A Critical Review of the Market Entry Mode Decision of Foreign Investors in the People's Republic of China

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by

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Declaration

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously, in its entirety or in part, submitted it at any university for a degree.

Abstract

The signing of the US-China bilateral trade agreement in November 1999 paved the way for the People's Republic of China (hereafter China) to ascend to World Trade Organisation as a member. China's bid to become part of the World Trade Organisation (WTO) renewed foreign investor interest after a decade of growth in foreign direct investment (FDI) in China.

An analysis of FDI to China confirms that foreign firms take an evolutionary approach to enter the Chinese market place. Since the opening of the economy to foreign investors in 1978, foreign enterprises shifted their utilisation of entry modes from contractual joint ventures (CJV), to equity joint ventures (EJV) and since 1994 many entered China without the help of a local partners through wholly foreign owned enterprises (WFOE's). Problems and frustration with joint venture partners gave rise to the growth in WFOE's. However EJV's are still superior in profitability and market share to the WFOE. Foreign investors need guidance in selecting the most appropriate entry mode. However, entry mode frameworks and models offered in literature are contradictory and fragmented.

Entry mode alternatives in China can be represented on a continuum of control. CJV's and minority EJV's represent the lowest level of control or ownership while the WFOE, the highest level of control. This study proposes that the entry mode decision can evaluated in terms of the level of ownership that a foreign investor should adopt in a foreign invested enterprise (FIE).

Turning to the theoretical foundations of entry mode choice, the transaction cost-, eclectic-, resource based -, strategic behaviour -, institutional- and evolutionary theories are integrated into a framework from which entry mode can be considered. From its theoretical foundations entry mode determinants are reviewed and propositions made regarding the impact of each determinant on the ownership level in a FIE.

A review of and application of the framework to the Chinese business environment resulted in the market entry mode decision framework for foreign investors in China (MEMDFFIC). The MEMDFFIC suggest a phased external-, internal-, partner and project analysis when considering entry mode choice. China's high market potential, experience in attracting FDI as well as high level of opportunism and weak intellectual property protection are proposed to motivate foreign investors to adopt high ownership levels when entering into China.

Opsomming

Die ondertekening van 'n bilaterale handelsooreenkoms deur die VSA en China in November 1999 het die weg gebaan vir die Volksrepubliek van China (hierna "China" genoem) om lidmaatskap van die Wêreldhandelsorganisasie (WHO) te verkry. China se pogings tot deelname aan die Wêreldhandelsorganisasie het die belangstelling van buitelandse beleggers laat opvlam na 'n dekade van groei in direkte buitelandse belegging in China.

'n Ontleding van direkte buitelandse belegging in China bevestig dat buitelandse firmas 'n evolusionêre benadering volg om tot die Chinese mark toe te tree. Sedert die oopstelling van die ekonomie vir buitelandse beleggers in 1978 het buitelandse ondernemings hul toetreemeganismes verskuif van kontraktuele gesamentlike ondernemings na ekwiteit gesamentlike ondernemings, en sedert 1994 het talle van hulle China binnegegaan sonder die hulp van plaaslike vennote deur middel van ondernemings ten volle in buitelandse besit. Dit was probleme en frustrasies met vennote in gesamentlike ondernemings wat tot die uitbreiding van laasgenoemde tipe ondernemings gelei het. Tog is billike gesamentlike ondernemings nog steeds winsgewender as ondernemings ten volle in buitelandse besit en geniet ook 'n groter markaandeel. Buitelandse beleggers het 'n behoefte aan praktiese leiding in die keuse van die geskikste toetreemeganisme, aangesien toetreeraamwerke en -modelle wat in die literatuur voorgehou word, mekaar dikwels weerspreek en ook gefragmenteer is.

Daar is wel toetreevlakalternatiewe in China op 'n kontinuum van beheer. Kontraktuele gesamentlike ondernemings en kleiner ekwiteit gesamentlike ondernemings verteenwoordig die laagste vlak van beheer of eienaarskap, terwyl daar by die ondernemings ten volle in buitelandse besit die hoogste vlak van beheer bestaan. In hierdie studie word voorgestel dat die toetrevlakbesluit geëvalueer kan word ingevolge die vlak van eienaarskap wat 'n buitelandse belegger behoort te aanvaar in 'n buitelandse beleggingsonderneming.

Wat betref die teoretiese grondslag van keuse van toetreevlak, word die transaksiekoste-, eklektiese, bron-, strategiesegedrag-, institusionele en evolusionêre teorieë geïntegreer in 'n raamwerk vanwaar toetreevlak oorweeg kan word. Vanuit die teoretiese grondslag word toetreevlakdeterminante geëvalueer en voorstelle gemaak oor die impak van elkeen op die eienaarskapvlak in 'n buitelandse onderneming.

'n Oorsig en toepassing van die raamwerk op die Chinese sake-omgewing het gelei tot die marktoetreevlak-besluitnemingsraamwerk vir buitelandse beleggers in China. Volgens die raamwerk word voorgestel 'n gefaseerde eksterne, interne, vennoot- en projekanalise wanneer die manier van toetrede oorweeg word. China se hoë markpotensiaal, ervaring van die lnk van direkte buitelandse belegging asook hoë vlak van opportunisme en swak beskerming van intellektuele eiendom moet gesien word as aansporing vir buitelandse beleggers om by toetrede tot China hoë vlakke van eienaarskap te aanvaar.

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Abbreviations

Abbreviation	Description
AIC	Administration of Industry and Commerce
AMC	Asset Management Company
CCP	Chinese Communist Party
CIFIT	China International Fair for Investment & Trade
CJV	Contractual Joint Venture
EJV	Equity Joint Venture
FDI	Foreign Direct Investment
FIE	Foreign Invested Enterprise
GDP	Gross Domestic Product
IJV	International Joint Venture
JSLC	Joint Stock Limited Companies
LLC	Limited Liability Companies
LME	Large and Medium Enterprises
M&A	Merger and Acquisition
MEMDFFIC	Market Entry Mode Decision Framework for Foreign Investors in China
MNC	Multi-National Corporation
MNE	Multi-National Enterprise
MOFERT	Ministry of Foreign Economic Relations and Trade
MOFTEC	Ministry of Foreign Trade and Economic Co-operation
PNTR	Permanent Normal Trade Relationship
PRC	People's Republic of China
RO	Representative Office
ROA	Return on Assets
ROC	Republic of China (Taiwan)
ROE	Return on Equity
ROI	Return on Investment
RSA	Republic of South Africa
SAEC	State Administration of Exchange Control
SBU	Strategic Business Unit
SOE	State Owned Enterprises
SPC	State Planning Commission
SSB	State Statistical Bureau

Abbreviation	Description
TVE	Town And Village Enterprises
UNCTAD	United Nations Conference on Trade and Development
US	United States of America
WFOE	Wholly Foreign Owned Enterprise
WTO	World Trade Organisation

1 Introduction

1.1 Introduction

The signing of the US-China bilateral trade agreement in November 1999 paved the way for the People Republic of China (hereafter China) to ascend to World Trade Organisation as a member. The signing of the agreement can be seen as one of the most significant market opening agreements ever. US companies will gain access to previously restricted industries like financial services and telecommunications, while significant reduction in taxes and duties are expected. In return the US, as the most powerful member of the WTO will back China's bid, and will grant China permanent normal trade relationship status (Beams (2000).

Interest in China steadily increased over the past 20 years as the world watched how the Government of the People's Republic of China (PRC) and more specifically, the China Communist Party (CCP), realised that it had no other option than to open China to the outside world.

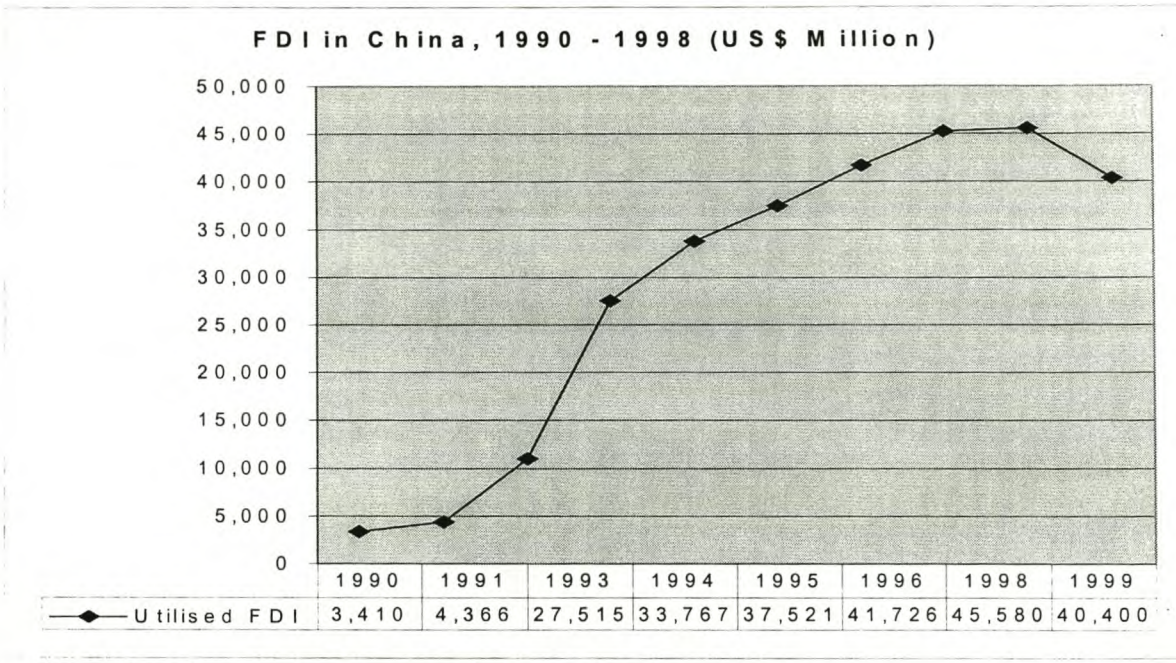
The Government was increasingly faced with vast problems in many areas: bankrupt and unproductive state enterprises, a depleted banking system due to handouts to state enterprises and increasing unemployment with millions of people that are living under the bread line (Smyth: 1998, Jiagui: 1998, Burns, J.P. 1999)

1.2 Description of Research Problem

Since the start of the reforms under the Regime of Deng Xiaopeng in 1978, China has sustained an average economic growth of over 10 % annually. With the continued reforms of Zheng Ziamen and Zhu Rongi China has managed to attract the most foreign direct investment of all the developing countries, 38% of the total FDI to developing countries. More than 200 of the world's top 500 multi-national corporations have established operations in China (Henley & Kirkpatrick: 1999).

Foreign investors encouraged by the recent reforms, and eager to establish a foothold in potentially the worlds biggest market, will continue to invest unprecedented amounts in the Chinese economy. Figure 1 illustrates the rapid growth in foreign investment in China since 1990.

Figure 1: Foreign Direct Investment in China, 1990 - 1999



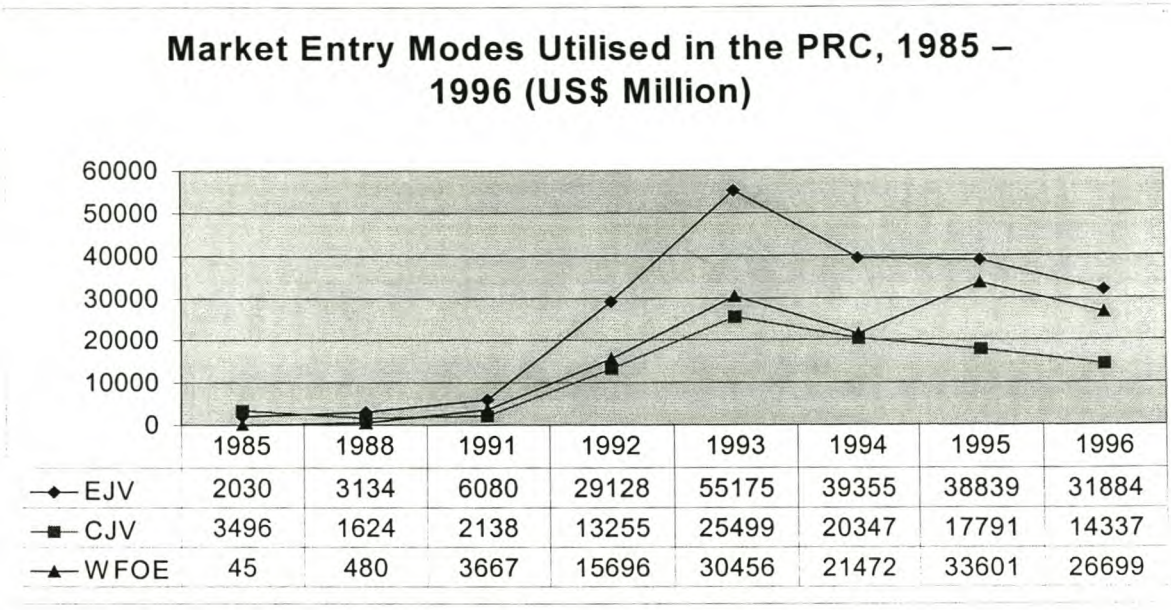
Source: US-China Business Council (1999), MOFTEC (1999)

1.2.1 Market Entry Modes for Foreign Investors in China

With the sharp rise of foreign direct investment in China, foreign investors became increasingly perplexed as to which mode of entry to utilise while entering China. Pan & Chi (1999) stress the impact of entry mode choice on foreign entrants' performance in the China market. Both profitability and market share influenced by entry mode choice.

In the early year's foreign investors was restricted to the use of contractual joint ventures (CJV), while as the legal framework evolved equity joint ventures and wholly owned foreign enterprises also became possibilities. Figure 2 illustrates the utilisation of foreign market entry modes in China since 1985.

Figure 2: Market Entry Modes Utilised in the PRC, 1985 – 1996.



	1985	1988	1991	1992	1993	1994	1995	1996
EJV	2030	3134	6080	29128	55175	39355	38839	31884
CJV	3496	1624	2138	13255	25499	20347	17791	14337
WFOE	45	480	3667	15696	30456	21472	33601	26699

Source: US-China Business Council (1999), MOFTEC (1999)

High levels of host country risk, uncertainty and lack of host country experience, coupled with government restrictions resulted in foreign entrants utilising the CJV for the majority of the investment projects. However, limitations with nature of CJV's, as well as government incentives, in a shift from CJV to EJV since 1988.

Regardless of the legal structure, many investors became increasingly frustrated by the limitations and problems imposed by the EJV, and the Chinese partner (Png: 1993, Madhok: 1995; De Bruijn & Jia: 1997; Yan & Zeng: 1999; Wong & Maher: 1999, Appel et. al. (1999). Increased host country experience provided the incentive for investors to increasingly desire higher ownership levels in EJV or to take full control of their operations through a WFOE. A number of practitioners and researchers have called for entering China by means of WFOE's (Tirbert: 1994, Rothstein: 1996; Wood: 1997; Economist Intelligence Unit: 1997; Vanhonacker: 1998). By 1995 the growth trend of WFOE'S indicated that it would become the most popular alternative for companies who seek more control of their operations. Current empirical research contradicts WFOE-advocates suggesting that EJV's performed better in both market share and profitability in China (Pan & Chi: 1999; Pan & Li: 1999). In 1999 EJV's were utilised only marginally higher than WFOE's (15.83 vs 15.55 US$ billion) (Gelb: 2000). In addition to EJV and WFOE's, Joint Stock Limited Companies (JSLC) emerged by 1996 as an alternative to invest via the stock markets in listed public companies enterprises. (Capener: 1998, Zaloom & Hongchuan: 1999)

1.2.2 The Market Entry Mode Decision

Each of the entry modes discussed represents different levels of ownership, risks, resource commitment and returns (Czinkot & Ronkainen: 1998, Kotabe & Helsen: 1998; Chee & Harris: 1998 and Mead: 1998). In other words the entry mode decision be reduced to the level of ownership level to be adopted in the foreign invested enterprise.

Much has been written with regards to the entry mode decision (Argwal et al.: 1992; Erramilli & Rao: 1993; Erramilli & D'Souza: 1993; Brouthers: 1993; Woodcock et al.: 1994; Tallman & Shenkar: 1994; Brouthers: 1995; Pan: 1996; Erramilli: 1996; Bell: 1996; Tse & Pan: 1997; Tsang: 1997; Madhok: 1997; Sharma: 1998; Van Den Bulcke et al.: 1999; Sun: 1999; Pan, Li & Tse: 1999; Pan & Chi: 1999, Padmanabhan & Cho: 1999; Delios & Beamish: 1999; Ding: 2000). However, no integrated framework exists that can guide the foreign investor in China with its market entry mode decision. The contradiction found in the research indicates that there is no simple right or wrong entry mode. All the relevant factors have to be consolidated in an integrated model that can guide investors given its specific investment situation.

1.3 Objectives of the Study

In view of the stated problem the primary aim of the study is:

- To develop an integrated market entry mode decision framework for foreign investors in China.

Secondary aims of the study includes:

- To critically review current market entry modes available for the foreign investor in China.
- To critically review and formulate propositions regarding determinants of entry mode choice.
- To integrate and consolidate determinants of entry mode choice in a general entry mode framework.
- To assess the Chinese business environment regarding the status of country-specific entry mode determinants.

1.4 Scope of the Study

The study was conducted within the following confines:

Although a host of market entry mode alternatives are available to foreign investors, only entry modes falling in the category of foreign direct investment in China have been considered for review.

Foreign investors need to consider a broader array of questions when entering into a foreign market such as timing-, location- and diversification decisions, this study is limited to the entry mode decision. In addition, the entry mode decisions are reduced to which level of ownership or control a foreign investor should adopt when entering into China.

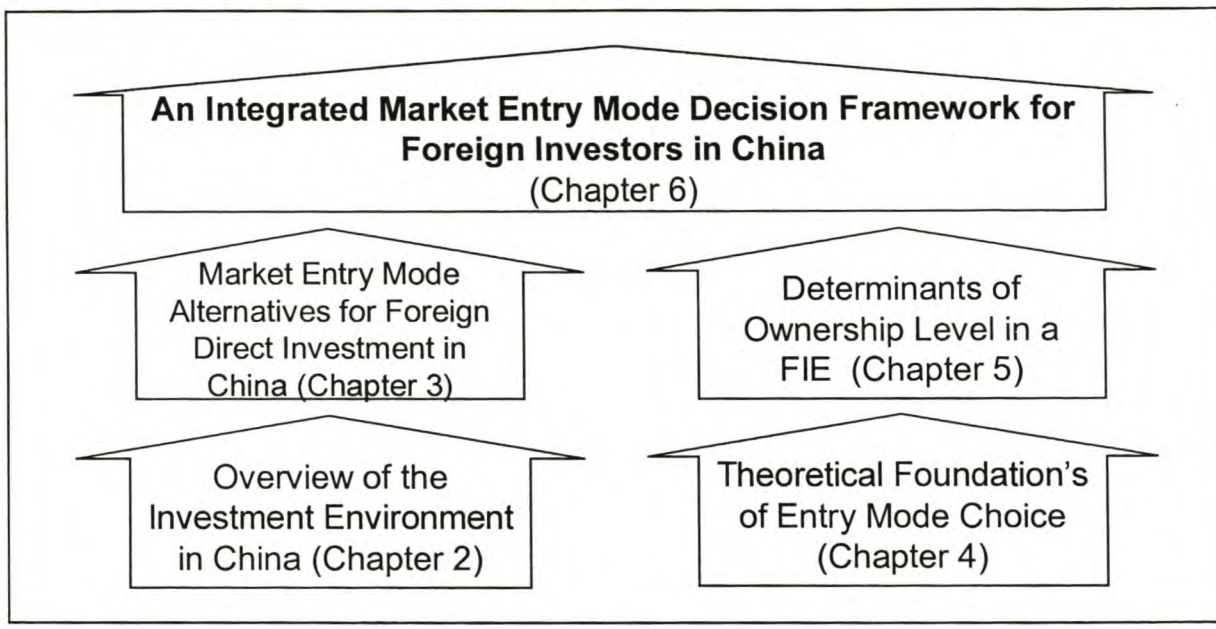
Although the majority of empirical research views entry mode choice from a western perspective, studies from non-western perspectives on entry mode choice were included in the review of literature.

The main focus of research performed on entry mode choice is specific to the manufacturing industry, while only a few studies applies it to the service sectors. The literature review includes both views, while the focus on the manufacturing perspectives are be dominant.

1.5 Method of Research

The study is limited to a literature review and extensive analyses of foreign direct investment data. Figure 3 indicates the research process that was adopted. Two pillars of literature were reviewed in order to achieve the aim of the study. First a basic literature overview of China's investment environment was performed. In the context of the general investment environment the entry mode options available for foreign direct investors in China were critically analysed.

Figure 3: Method and Structure of the Study



Once the context for entry mode choice in China has been set, the study turned to the general entry mode literature. Since most of the empirical performed are based on one or the other theory, an extensive review was done of the foundational theories of entry mode choice. From its theoretical departing points general entry mode choice determinants were identified and surveyed.

Propositions are offered for each determinant of entry mode choice, and are integrated into a general entry mode decision framework. Each proposition represents the conclusion or suggested impact of the relevant entry mode determinant on the ownership level of a FIE. Finally the China-specific entry mode determinants were identified and integrated into the general entry mode framework. The impact of China specific entry mode determinants on ownership level in foreign invested enterprises were assessed and propositions offered.

1.6 Summary

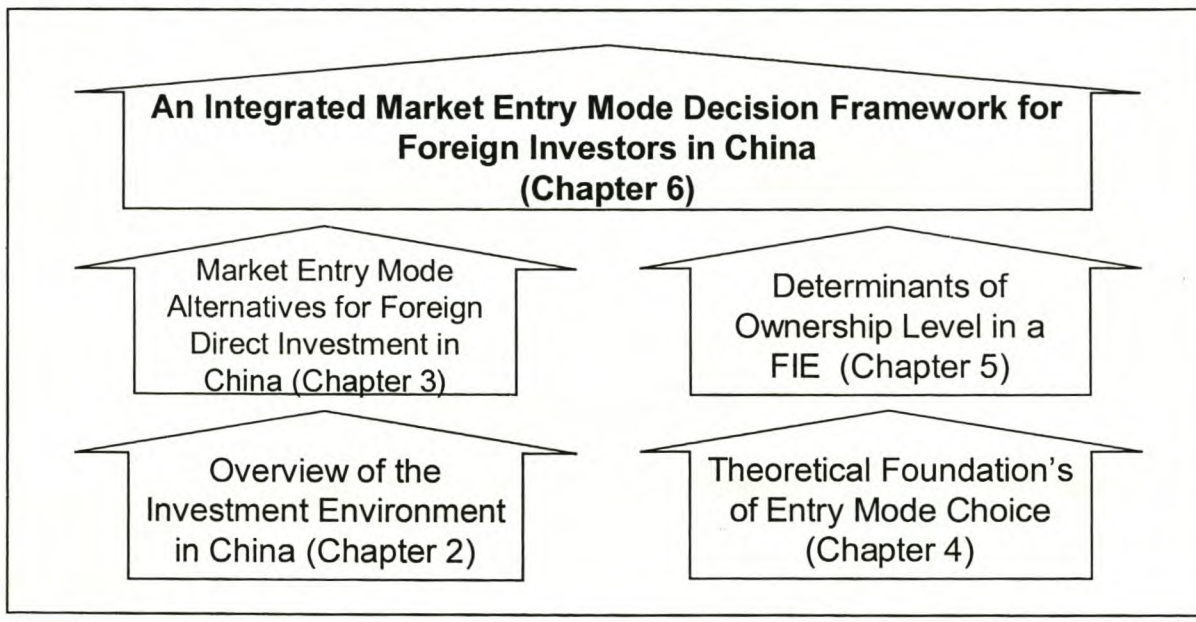
China's bid to enter the WTO has renewed foreign investors' interest. Foreign investment in China in recent years has seen explosive growth. Frustration with the CJV and EJV has increased the need for a framework to guide the foreign investor in deciding on an entry mode or the level of ownership that it should adopt while entering in China. However, existing entry mode literature is contradictory and fragmented in its approach to offer guidance to foreign investors. This study aimed to integrate entry mode determinants into a integrated framework for entry mode choice in China.

2 China's Investment Environment

2.1 Introduction

The first building block towards the unfolding of a market entry mode decision framework for China will be the review its investment environment (see Figure 4). China's economy and business environment over the past 21 years were characterised by a phased or gradual opening to the outside world. Each phase opened new opportunities for investors, and impacted especially the mode in which foreign entrants do business in China. Notable are the current reforms of China's state owned enterprises and trends in foreign direct investment to China.

Figure 4: Market Entry Mode Decision Building Block One



Chapter 2 will therefore aim to review the history of market reforms in China, provide a background to the reforms in state owned enterprises (SOE's), as well as to analyse foreign direct investment to China. This review will provide a basis from which market entry mode can be reviewed.

2.2 Market Reforms in the People's Republic of China since 1949

Contrary to the perception that the government of the People's Republic of China (hereafter China) has embraced a market economy with a full democratic system, Burns (1999) suggests that quite the opposite is true. In a very enlightening article he proposes that after

50 years of revolutionary reform, the political institutions of China remain essentially Leninist. 'The Chinese Communist Party (CCP) continues to enjoy monopolistic power, independent media, autonomous trade unions and other manifestation of civil society are almost wholly absent' (1999: 580).

'Since 1949, the Chinese Communist Party (CCP) has maintained itself in power through its control over leadership selection in all strategic groups, and control not only government agencies but the legislature, judiciary, the military, strategic economic enterprises, the media and mass organisations such as the All China Federation of Trade Unions' (1999: 582).

2.2.1 Economic Policy Regime of Mao Zedong (1952-1975)

Dernberger (1999) describes the political regimes and economic reforms since 1949: Shortly after Mao came to power in 1952, he went to Russia where he studied the Soviet communism model for three months. Upon his return he implemented the communism model in China.

Farmers who for more that 40 centuries worked their own land and sold their own produce suddenly found themselves as part of as a production team within a commune, losing title to their land and working in work groups for work points. Their markets were replaced by planned allocation of resources. Banks, domestic- and foreign trade and enterprises were nationalised. Central planners set targets for production and prescribed how it should be produced and who the consumers will be. Prices and transactions became merely book entries with no cash values.

Mao did however implement modifications to the soviet communistic model by 1957. The modifications include a degree of decentralisation where central directives were seen as guidelines for the lower level cadres to interpret and implement. Lower-level conferences among suppliers and users work out delivery, contracts and schedules. And extreme emphasis was placed on self-dependent economic development on national, regional, provincial and enterprise basis.

Dernberger (1999) stress that the central planned economy had delivered some fruit such as an average annually growth rate of 6.7% in gross domestic product (GDP). However, growth was obtained through forced savings into relatively high rate of investment in fixed capital, which led to inefficiencies that grew over time.

2.2.2 Economic Reforms under Deng Xiaopeng (1978 – 1995)

The death of Mao Zedong and the arrest of the band of four, his radical followers, provided an opportunity for a change in leadership and economic policy. During the third plenum of the 11th CCP Central Committee in November 1978, Deng emerged as supreme leader.

Deng had to focus on the most serious problems he inherited from Mao. Kapp (1998) describes Deng's basic economic policy as enlivening the economy and opening to the outside world. Kapp (1998) also refer to Deng's four modernisations – agriculture, industry, national defence and science and technology.

On the agricultural front, peasants were allowed to abandon communes and revert to subsistence farming. They were also allowed to sell their produce relatively freely on local markets. The State, however, still claims residual ownership rights and a right to interfere in the markets. (Dernberger: 1999)

Deng opened the economy to foreign trade and investment and joined global economic institutions. In 1979 China and the US established full diplomatic relations, and in the spring of that year new laws were passed allowing foreign investors to set up representative offices as well as sino-foreign joint ventures. Import/ export licences were granted and foreign exchange controls implemented. Special economic zones were authorised and foreign direct investment started to flow in. (Kapp: 1999)

State owned enterprises (SOE) were forced to go to markets and had to buy inputs and sell outputs. Domestic and foreign enterprises could be created to compete with SOE's. It soon became clear that reform of the monetary and fiscal sectors were required. The State remained responsible for infrastructure projects, but most investment activities were now financed through the People's Bank of China as the central bank. Other banks became the commercial banks that offered normal services to their customers. To preserve revenues the tax systems needed to be reviewed and higher direct taxes on individuals were imposed. (Dernberger: 1999)

At his death in 1995 the reforms of Deng were far from complete, but impressive results were showing. An average of 9.8% economic growth was achieved. The structure of the economy was adjusted so that the service industry regained its rightful share of the economy, 30.7%. By 1995 China became the 7th largest participant in world trade, with foreign direct

investment in 233 564 enterprises of which 40% of the US$639 billion came from foreign participants. (Dernberger: 1999)

2.2.3 Economic Reforms under Ziang Zemin and Zhu Rongji (1996 – 1999)

Ziang and Zhu also inherited economic problems from Deng. The economic growth declined from 14% in early 1990's to only 7% in 1999. The previous sources of economic growth started to slow down. Rapid growth of agriculture and town and village's enterprises (TVE's) slowed down. Fortunately between 1985 - 1997 FDI was sustained and exports grew 27.7% annually. However since 1996 FDI decreased to below 10% growth per year. (Dernberger: 1999)

Ziang and Zhu were increasingly faced with the difficulty of obtaining increases in efficiency in SOE's, and were losing millions of Yuan annually due to SOE losses. Bad loans to state enterprises created the problem of insolvency in the banking system. Not only did the bank suffer, the government developed its own budget problems. State revenue declined to 10.7% of the GDP in 1995. Despite tax reform, revenues increased only with 1 % by 1997. An increase in corruption and a worsening of regional and class-distribution of incomes further added to the load. (Dernberger: 1999)

2.3 Reform of State-Owned Enterprises

An understanding of the state-owned sector with its limitations and recent reforms creates more options for foreign investors in dealing with the government and obtaining business rights. Jiagui (1998) describes four phases of enterprise reform between 1978 – 1996:

2.3.1 Phase 1: 1978 – 1984

The government conducted pilot schemes where decision making was decentralised to the SOE's. SOE's were also allowed to retain profits for allocation at their own discretion.

2.3.2 Phase 2: October 1984 – December 1986

Diverse management forms were introduced with the main focus on the contract system. Further decentralisation of decision-making power was endorsed, as well as the separation

of government functions from enterprise management. Trials were conducted with the shareholding system in few enterprises.

2.3.3 Phase 3: 1987 – 1993

Management mechanisms were further transformed with the main focus of improving the contract system. The government formulated provisions on the contract system. It also defined fourteen categories of decision-making, and relaxed the state planning and price control of SOE's.

2.3.4 Phase 4: 1994 – 1996

At the third plenary session of 14th party central committee gathering, the government committed itself to modernise SOE's in line with demands of a market economy. In doing so it defined property rights, demarcated power, and further separated the function of government and enterprise management. It adopted scientific management principles and encouraged large and medium SOE's to group into limited liability companies.

2.3.5 Phase 5: 1997 – 1998

Smith (1998) describes the recent developments in the institutional reform of state-owned enterprises. 'At the Chinese Communist Party's 15th congress held in September 1997, the central committee endorsed both the corporatisation of large state-owned enterprises and the restructuring of small SOE's and decided to step up the speed of reforms. The central component of the government's reform program is "zhuada, fangxiao" – grasping the big, enlivening the small' (1998: 102).

In dealing with the deteriorating financial position of the state sector the most important decision was to restructure China's large and medium sized (LME's). The focus is on the largest 1000 SOE's. These top 1000 comprise only 2.8% of all SOE's, but represent 63% of the total assets, 69% of output value and 74% of revenues. Strategies to reform these SOE's include the following:

Firstly, to convert large and medium sized (LME's) into joint stock companies or limited liability Companies in which each shareholders liability is proportionate to the investment. Better performing LME's will be listed on the Shanghai, Shenzhen, Hong Kong or New York stock exchange, where shares are divided in different kinds. A-shares which are reserved for

domestic investors and denominated in renminbi and B-shares which are restricted to foreigners and denominated in U.S dollar. This new kind of joint stock limited companies created opportunities for foreign investors to be involved by means of equity investment.

A second strategy is to create additional large enterprise groups in strategic pillar industries. Jiang Zemin hopes to create these industries to be able to have several enterprises in the Fortune 500 by the year 2010. China, when forced to open its domestic markets in becoming part of the World Trade Organisation, wants to have a strategic stance in these pillar industries against foreign competitors. Large enterprise groups are especially focused in the petrochemical and automotive industries.

A third strategy focussing on the small scale SOE's is to allow bankruptcies of SOE's. Since 1990–1996 bankruptcies increased from 32 – 6332 p.a. In some cases, bankrupt enterprises were allowed to be taken over by other firms or enterprise groups.

Fourthly, small scale SOE's were allowed to become shareholding co-operatives. In a shareholding co-operative system, management and workers are sold shares equivalent to the net assets of the enterprise. In some cases loss-making enterprises have been given to workers for next to nothing.

The Government is also willing to auction off, lease, or even sell off SOE's as a fifth alternative. But where a purchaser cannot be found or the sale is politically sensitive the SOE's have been leased to the private sector. Some SOE's have sold leasehold land rights to commercial occupants. Often SOE's occupy prime locations in the middle of the city where real estate is the most valuable. The World Bank estimates the total value of state owned land in China as 15 trillion yuan. This means that there is an enormous scope to sell land-use rights to raise capital to facilitate restructuring. Willingness to sell off SOE's creates a further opportunity for foreign investors to obtain valuable land, assets and personnel for a quick start by means of these acquisitions.

The government also encourages profit sharing arrangements with managers. For example in the Xinfang Enterprise Development company, six managers contributed 100 000 yuan to receive proprietary interest in the firm. They should earn profits of 200 000 yuan within the first year.

Finally since 1992 some SOE's have entered into joint ventures with foreign investors, referred to as 'grafting'. Two main approaches exist: (1) SOE's convert their assets

(buildings, equipment, land-use rights) into shares in the joint venture, while the foreign partner provides capital. (2) SOE's convert into shareholding companies or joint stock co-operatives and transfer part of their shares to foreign investors. SOE's also enter into joint ventures with non-state sector.

2.3.6 Phase 6: 1999 – 2002

The Beijing Review (October 11, 1999) published the 'Decision of the Central committee of the CCP of China on major issues concerning the reform and development of SOE's', adopted at the fourth plenum of the 15th CPC Central Committee on September 22, 1999.

The document describes the remaining problem of SOE's as the following: 'redundant construction, inflexible operations, weak in technical innovation, heavily in debt and social burdens, surplus workers, and dropping economic returns' (1999: 19).

Among a list of 11 initiatives the government also continues to 'push forward strategic restructuring of SOE's', 'improve the balance of SOE debts and assets and reducing SOE social burdens' and 'speed up technological progress and industrial upgrading of SOE'S' (1999: 19).

Debt/Asset swaps is an additional important programme of the government in order to relieve the over-burdened state banks of SOE debt. First the government created so-called asset management companies (AMC). Asset management companies pay off the debt from qualified SOE's in return for equity in the company. The AMC will then agree upon actions with the SOE to streamline the company's operations, and to bring it in a profitable position. One of the measures may be to re-capitalise the enterprise by selling it to private or foreign investors.

2.4 Implications of Economic- and State Owned Enterprise Reform for Foreign Investment in China

A number of opportunities arise for the foreign investor, due to the economic- and SOE reform in China:

First, continued economic reform opens the scope for foreign investment in a number of ways: Additional investment vehicle alternatives, added investment locations, and more

industries are open to investment. The entry mode alternatives and location decisions become more relevant to the foreign investor.

Second, the privatisation of SOE's and especially the dept/equity swap program create opportunities for investors to acquire existing enterprises in part or completely. The question whether to enter China by means of de novo vs acquisitive entry becomes more relevant.

Thirdly, joint stock limited companies (JSLC) also give foreign investors the opportunity to invest more flexibly, by means of the stock exchanges in China.

2.4 Foreign Direct Investment in China, 1979 – 1999

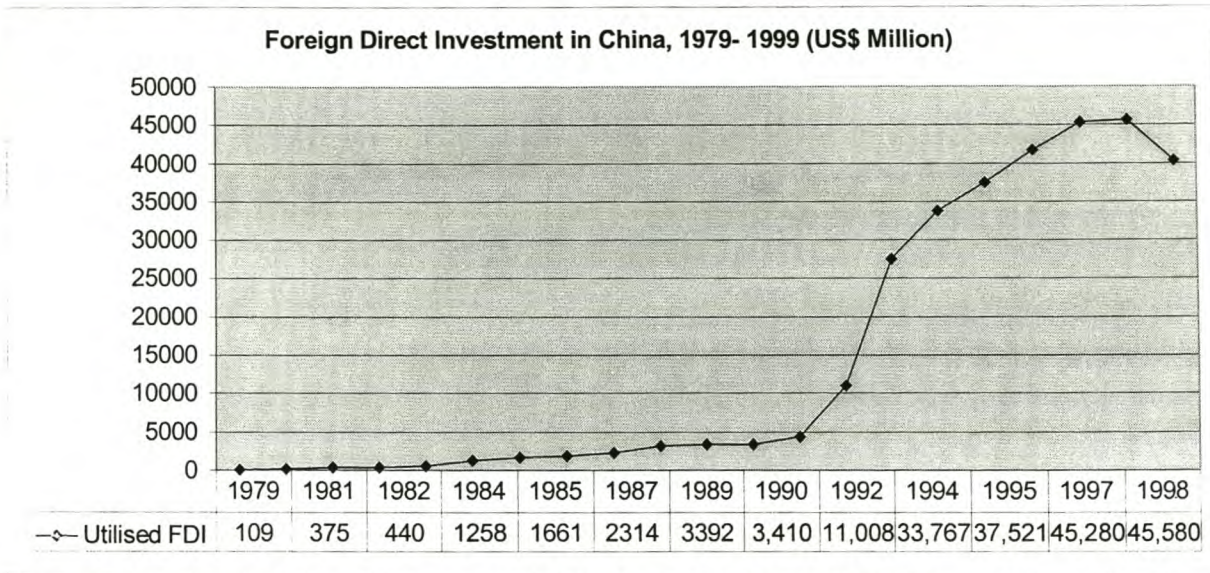
The United Nations Conference of Trade and Development (UNCTAD(c): 1999) define foreign direct investment as an investment from an entity in one economy to another country that involves management control. In view of the increased opportunities for foreign direct investment and the resulting entry mode decisions, characteristics and trends of FDI in China will shortly be reviewed.

2.4.1 Current Levels of Foreign Direct Investment in China

2.4.1.1 Actual Utilisation of Foreign Direct Investment in China, 1979 – 1999.

A steady increase in actual utilisation of FDI took place between 1979 – 1990 in China (see Figure 5). Between 1991 and 1998 FDI levels increased tenfold from US$ 4.36 Billion to US$ 45.58 Billion. However from 1998 a negative growth in FDI resulted in FDI levels lower than realised in 1996, US$ 40.4 Billion.

Figure 5: Foreign Direct Investment in China, 1979 - 1999



Sources: US-China Business Council (2000), China Statistical Information Network (1999)

2.4.1.2 Annual Growth in Actual Utilisation of Foreign Direct Investment in China, 1979 – 1999.

Figure 6 highlights growth patterns of actual utilised FDI in China since 1979. The two lowest points of growth have been in 1988 and 1998. The first can be explained by the worsening economic climate and the political instability during the time of the Tiananmen Square Massacre. The latter may still be the result of the Asian crises of 1998. A slow recovery of 2.7% growth in actual utilised FDI was realised in the first six months of 2000. Growth rates in excess of 150% were achieved between 1991–1993. But since 1993, growth declined strongly up to an all time low in FDI growth rate of –11.36%.

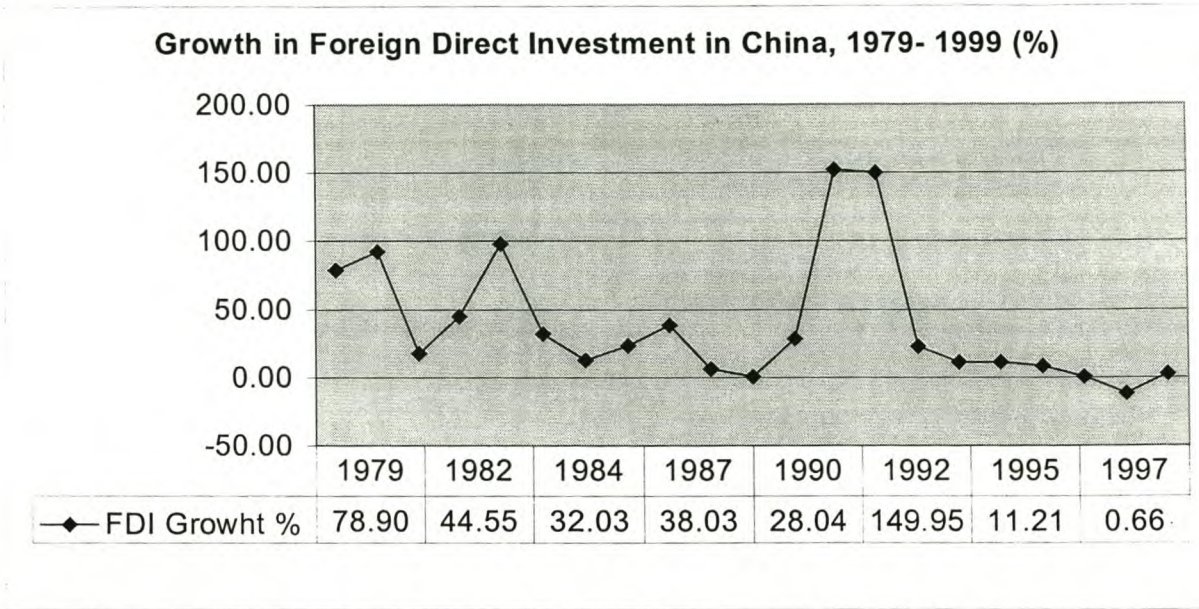
2.4.2 Phases in the Development of Foreign Direct Investment to China

Sun (1998) offers a brief overview of the phases of FDI, which will explain the patterns of FDI as highlighted in 2.4.1.1and 2.4.1.2

2.4.2.1 Phase 1: 1979-85

Foreign direct investment in China started in 1979 with the promulgation of the joint venture law and the establishment of four special economic zones in Guangdong and Fujian. In 1984 another 14 coastal cities were opened for foreign investment, leading to the first boom of foreign investment in 1984-85. High inflation and a lack of legal clarity, however, led to a slump in growth. During this period investment was concentrated in small-sized assembling for export.

Figure 6: Annual Growth in Foreign Direct Investment in China, 1979-1999



Sources: US-China Business Council (2000), China Statistical Information Network (1999),

2.4.2.2 Phase 2: 1986-89

In response to the slump in growth the government promulgated in 1986 'Provisions for the encouragement of foreign investment', followed by set of central, provincial and municipal regulation for implementation. The government also clarified the legal framework for foreign investment and increased the number of economic and technological development zones in coastal areas. These actions lead to another growth period. Growth however slowed down again towards 1990 due to a worsening economic and political environment. Seventy percent of the investment projects were focused on manufacturing during this phase.

2.4.2.3 Phase 3: 1990-1997

Amendments to the joint venture law in April 1990, and the standardisation of the income tax law for enterprises with foreign capital and foreign enterprises (1991) were made in response to the worsening economic climate. In 1992 the government adopted the socialist market strategy and stepped up market reforms. A host of commercial law's were passed, including the Companies Act (1994) and the Regulations on the Establishment of Foreign Funded Joint Stock Limited Companies. All these laws and regulations provided a legal framework for foreign investors. FDI surged from only US$ 3.4 Billion in 1990 to US$ 45,5 Billion in 1997.

2.5 General Characteristics of FDI to China

Luo & O'Connor (1998) suggests that the contextual environment and corporate investment strategy has dramatically changed during the past two decades in China. Changes in the structure of FDI in terms of entry mode, industry selection, project location, investment size and operational features are taking place. Foreign businesses follow an evolutionary approach in gradually increasing their investment commitment to the local market and operation, while incrementally heightening their pro-activeness and risk-taking.

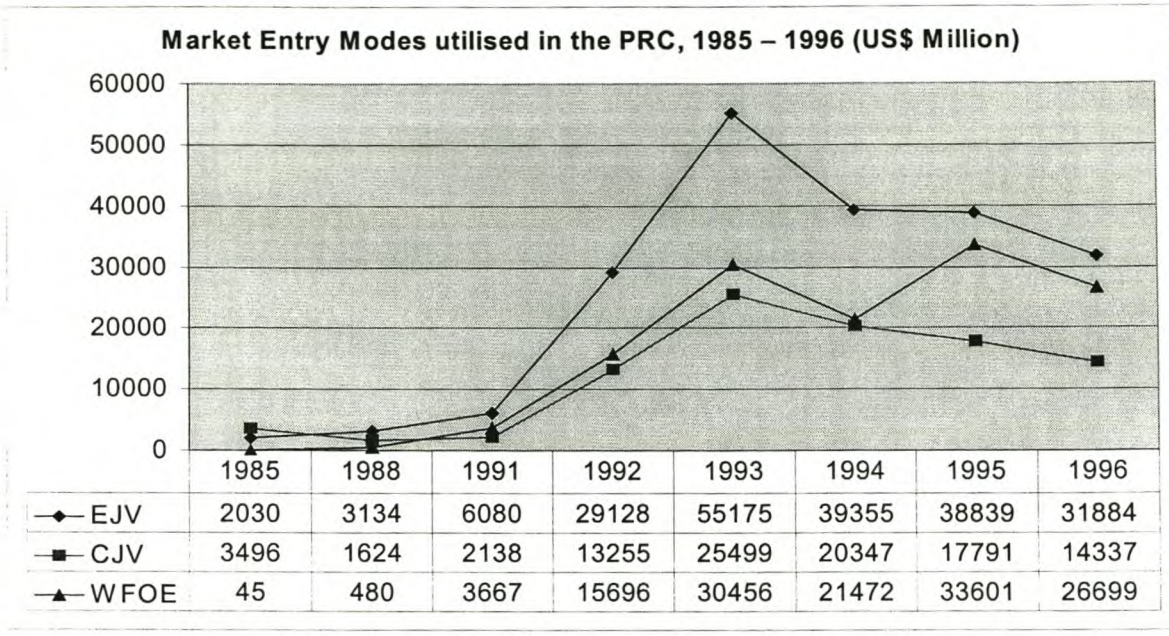
Foreign investors increase their resource commitment as they gain experience, learn and adapt their strategies in a foreign market. Multi-national corporations (MNC's) in China purposefully incrementally increased their commitment and investment in local operations. They are not only entering the market to take advantage of labour costs, but are there for the long haul. They have through accumulated knowledge learned to build profits and sustain them.

Three phases of investment were identified. First the opportunistic experimenter phase. The investor will only set up a representative office or some small operation as an experiment or base to learn the local conditions and opportunities. As knowledge and learning increase, the foreign investor will become a strategic investor. During this phase key investments will be made to establish the investor in the local market until it becomes a dominant local player. In the final phase the foreign investor will continue building the enterprise to maintain its majority position and to keep competition out.

2.5.1 Structural Changes to Market Entry Modes

Foreign investors initially entered China by means of CJV's. As they gained more experience in the local market, other options like EJV's became more popular (Luo & O'Connor: 1998). Figure 6 shows the value of contracted foreign direct Investment between 1985 – 1996 for the CJV, EJV and the WFOE.

Figure 7: Market Entry Modes utilised in the PRC, 1985 – 1996.



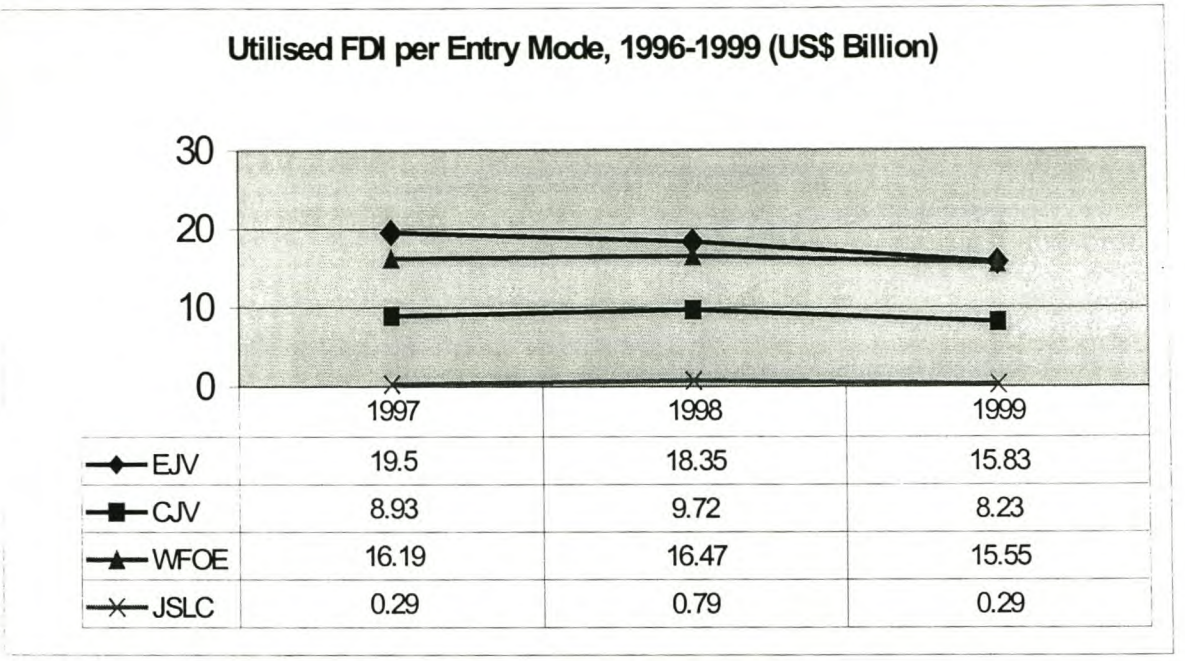
	1985	1988	1991	1992	1993	1994	1995	1996
EJV	2030	3134	6080	29128	55175	39355	38839	31884
CJV	3496	1624	2138	13255	25499	20347	17791	14337
WFOE	45	480	3667	15696	30456	21472	33601	26699

Sources: US-China Business Council (2000), China Statistical Information Network (1999)

The EJV were the preferred entry mode since 1988, but its use sharply declined from 1993 to 1996. The promulgation of the company law of 1994 gave rise to a rapid increase in the use of WFOE's. In 1995 the growth trend of WFOE's indicated that it will become the preferred mode of entry into China. However, with the decline in FDI to China both the utilisation of WFOE's and EJV's declined. The CJV lost it power as a main entry mode for foreign investors. CJV's are reserved for shorter-term infrastructure and exploration projects.

The utilisation of WFOE's as opposed to EJV's still increased between 1996 and 1999, with the actual utilisation of WFOE's at US$ 15.55 billion, while EJV are only marginally higher with US$ 15,83 billion (see Figure 8). Moreover the utilisation of EJV's were reduced consistently in the past three years.

Figure 8: Utilised FDI per Entry Mode, 1996 -1999



Source: Gelb (2000: 6-14)

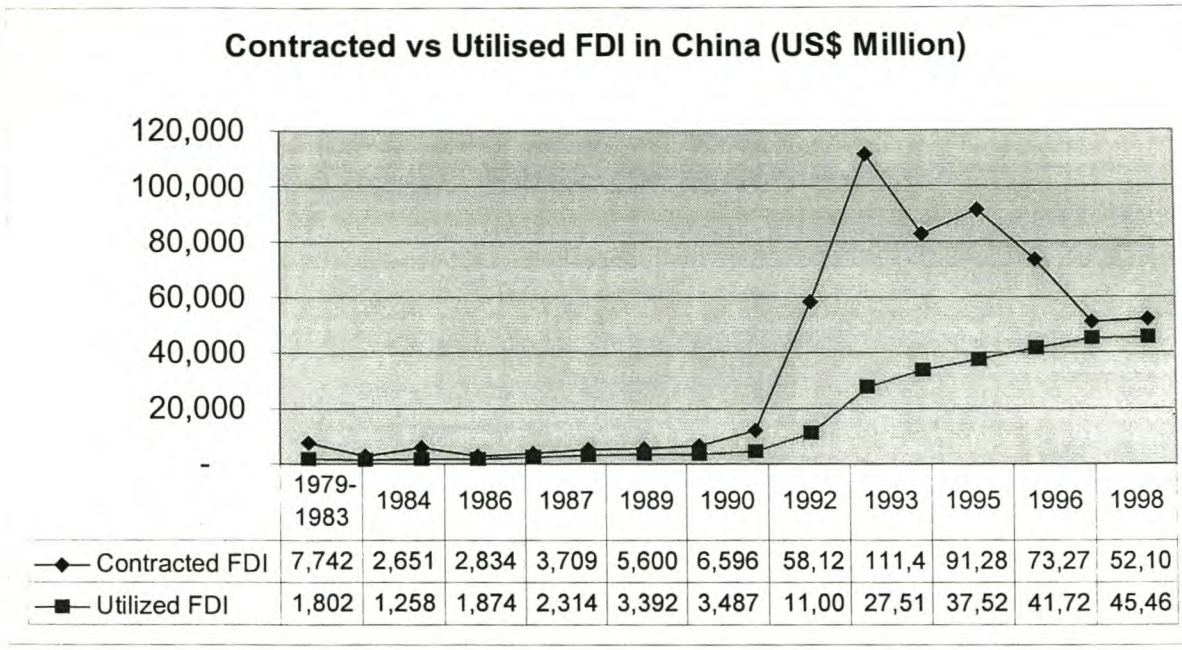
2.5.2 Structural Changes in Investment Size

Figure 9 indicates that only a marginal difference between contracted FDI and actual utilised FDI between 1979-1989. Since 1990 however, contracted FDI rose from US$6.5 billion to an amazing US$ 114,4 billion. An increase of more than 1700% in contracted FDI. Since contracted FDI indicates the growth in actual FDI, the high levels of contracted FDI can explain the steady growth of actual FDI in the following years.

In a similar dramatic way, contracted FDI decreased to a low of US$ 52.1 Billion. The negative growth in contracted FDI explains the continued downward trend in actual FDI. The current low levels of contracted FDI indicate that no dramatic increases in actual FDI can be expected in the short term.

Figure 10 portrays the contracted vs. the actual utilised number of FDI projects. The growth curve of the contracted vs actual utilised number of FDI projects, shows a similar pattern to Figure 9. A dramatic number of 83 347 contracted projects has been approved in 1993. The numbers of contracted projects gradually decrease to 19 749 in 1998. The number of actual utilised projects steadily increased from 27 in 1998 to 644 in 1997, and then decreased to 585 projects in 1998.

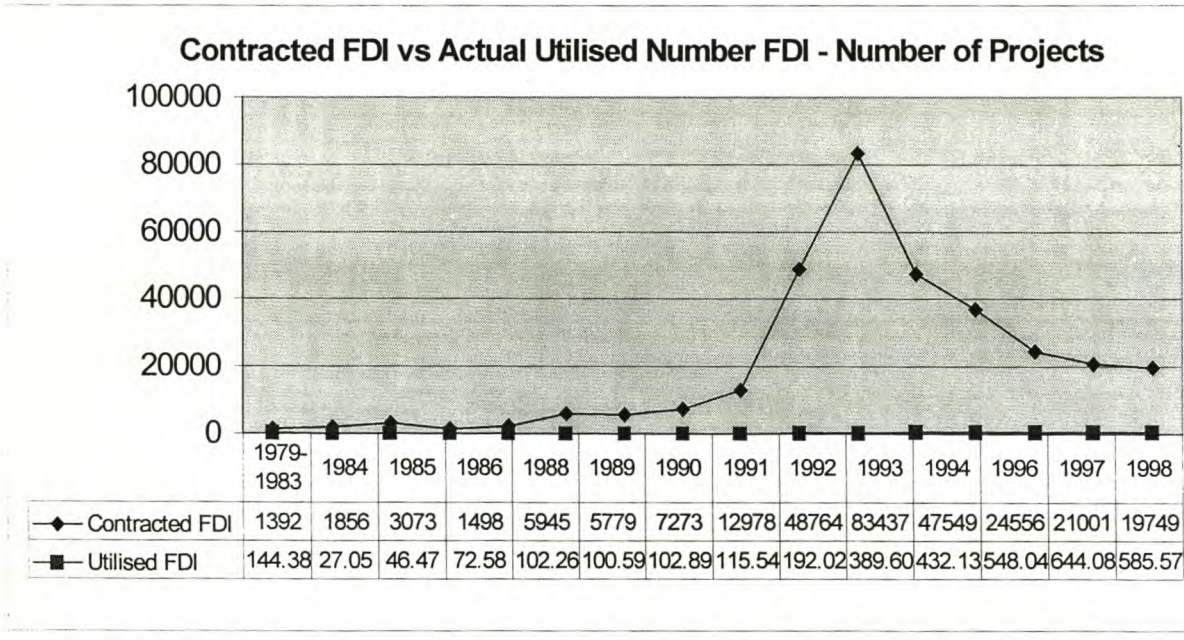
Figure 9: Contracted vs Utilised FDI in China, 1979 – 1998



	1979-1983	1984	1986	1987	1989	1990	1992	1993	1995	1996	1998
Contracted FDI	7,742	2,651	2,834	3,709	5,600	6,596	58,12	111,4	91,28	73,27	52,10
Utilized FDI	1,802	1,258	1,874	2,314	3,392	3,487	11,00	27,51	37,52	41,72	45,46

Source: China Statistical Handbook 1999, China Statistical Information Network (1999)

Figure 10: Contracted vs Actual Utilised FDI - Number of Projects, 19979 - 1998



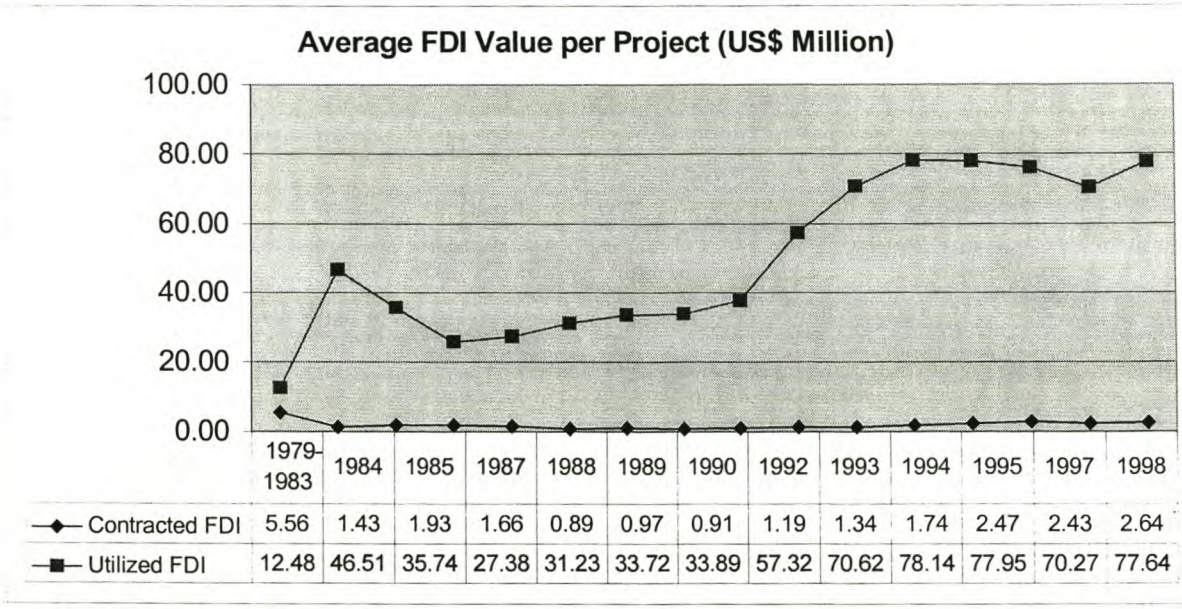
	1979-1983	1984	1985	1986	1988	1989	1990	1991	1992	1993	1994	1996	1997	1998
Contracted FDI	1392	1856	3073	1498	5945	5779	7273	12978	48764	83437	47549	24556	21001	19749
Utilised FDI	144.38	27.05	46.47	72.58	102.26	100.59	102.89	115.54	192.02	389.60	432.13	548.04	644.08	585.57

Source: China Statistical Handbook 1999, China Statistical Information Network (1999)

Figure 11 shows the average value of actual utilised FDI increased since 1986 from US$ 25.82 million to US$ 77.64 million in 1998, after declining slightly from 1995. The increase in

average value may be explained by a stronger commitment to the Chinese market by foreign investors as they gained experience in the Chinese market place (Luo & O'Connor: 1998).

Figure 11: Average FDI value per Project



	1979-1983	1984	1985	1987	1988	1989	1990	1992	1993	1994	1995	1997	1998
Contracted FDI	5.56	1.43	1.93	1.66	0.89	0.97	0.91	1.19	1.34	1.74	2.47	2.43	2.64
Utilized FDI	12.48	46.51	35.74	27.38	31.23	33.72	33.89	57.32	70.62	78.14	77.95	70.27	77.64

Source: China Statistical Handbook 1999, China Statistical Information Network (1999)

2.5.3 Structural Changes in Industry Participation of FDI in China.

The evolutionary approach suggests that industrial participation will develop as knowledge and experience in the market develops. In the initial phases of investment, foreign companies operate in less capital and technology-intensive industries such as food, toys, and textiles. As experience increases foreign companies extend their investments to high-tech and capital intensive industries such as telecommunications and infrastructure projects. (Luo & O'Connor: 1998) Table 1 indicates the sector distribution of FDI to China.

The manufacturing sector is by far the biggest receiver of FDI in China. US$ 25,58 million, 56% of the total realised FDI. This sector however shows a decline of 9% in receiving FDI between 1997 - 98. Real estate management also proves to be an important sector by attracting US$ 6,4 million or 14% of the FDI. The more than 40% growth in FDI in sectors 3, 4and 5 (Electric Power, Gas and Water Production and Supply; Construction) confirms Luo & O'Connor's (1998) statement that with increased experience foreign firms will invest in more capital intensive industries.

2.5.4 Structural Changes in Project Location of FDI in China

A major characteristic of FDI to China, as illustrated in Figure 12, is the unequal distribution of FDI to the various provinces. The trend can be related to the history of systematic opening up to the outside world, first to the special economic zones and then to the opening of the coastal cities.

Table 1: Sector Distribution of FDI to China, 1998 (US$ 10 000)

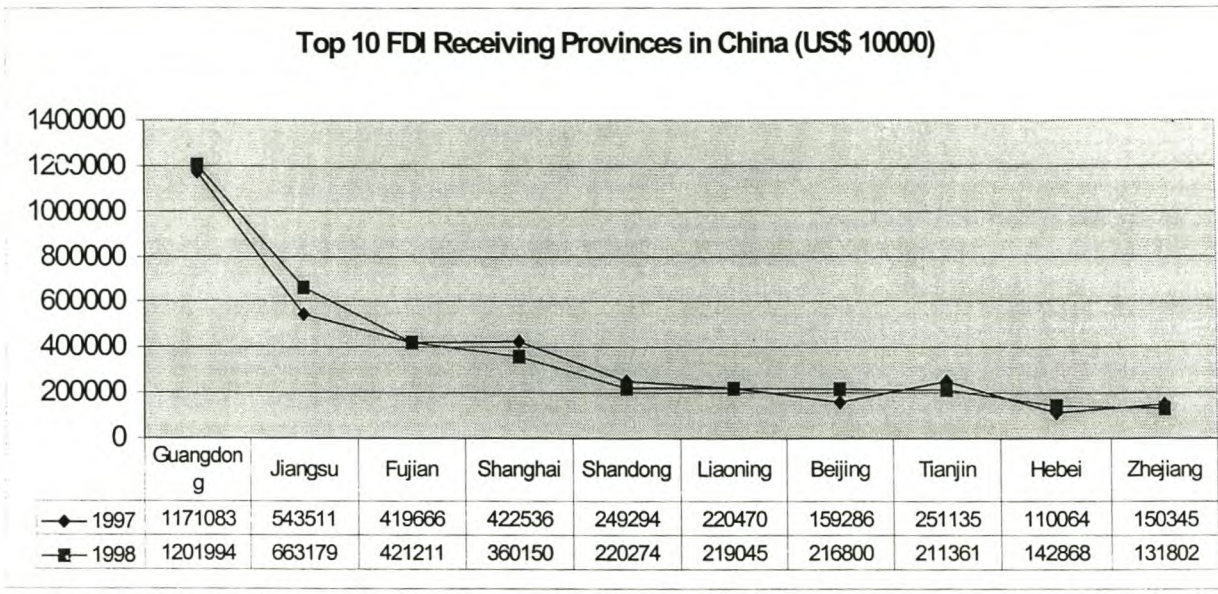
Unit: US$ 10 000		Value of Projects			
	Sector	1997	1998	% Change	% of Total
Nr.	**National Total**	**4,867,049**	**4,797,627**	**-1.4**	**100**
1	Manufacturing	2,811,983	2,558,238	-9.0	56.3
2	Real Estate Management	516,901	641,006	24.0	14.1
3	Electric Power, Gas and Water Production and Supply	207,191	310,279	49.8	6.8
4	Social Services	198,802	296,315	49.1	6.5
5	Construction	143,782	206,423	43.6	4.5
6	Transportation, Storage, Postal and Telecommunications Services	165,513	164,513	-0.6	3.6
7	Wholesale & Retail Trade and Catering Services	140,187	118,149	-15.7	2.6
8	**Other Sectors**	**157,611**	**114,614**	**-27.3**	**2.5**
9	Farming, Forestry, Animal Husbandry and Fishery	62,763	62,375	-0.6	1.4
10	Mining and Quarrying	94,033	57,809	-38.5	1.3
11	Health Care, Sports and Social Welfare	19,535	9,724	-50.2	0.2
12	Education, Culture and Arts, Radio, Film and Television	7,403	6,830	-7.7	0.2

Source: China Statistical Handbook 1999, China Statistical Information Network (1999)

The Guangdong province in 1998 realised a FDI level of US$ 12,01 billion or 26 % of the total FDI to China. Similarly the Jiangsu Province realised US$ 6,63 billion or 15 % of the total FDI to China. All of the top 10 FDI receiving provinces are part of the coastal area. The other 21 of 31 provinces received only 16% of the FDI to China. These trends clearly confirm a very uneven distribution of FDI among the provinces.

Despite the uneven distribution, structural changes in project location are also taking place. As experience and learning increased, companies invested in all parts of China. In 1990 only 333 foreign invested enterprises (FIE's) invested in the interior. By 1995, 44 875 FIE's were found in the interior of China (Luo & O'Connor: 1998).

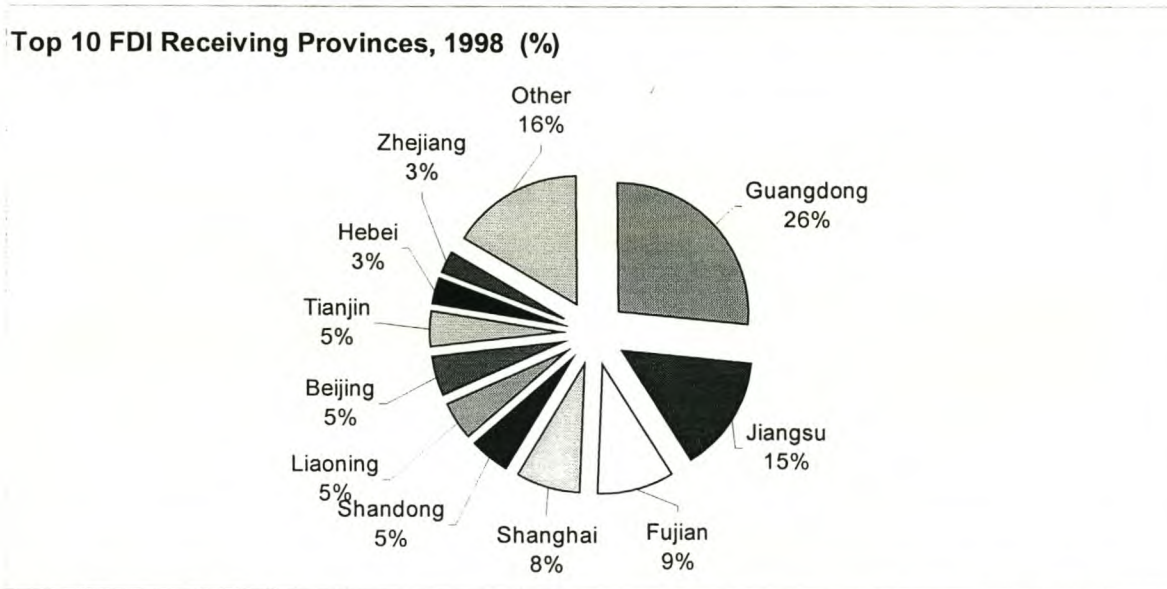
Figure 12: Top 10 FDI Receiving Provinces in China



	Guangdong	Jiangsu	Fujian	Shanghai	Shandong	Liaoning	Beijing	Tianjin	Hebei	Zhejiang
1997	1171083	543511	419666	422536	249294	220470	159286	251135	110064	150345
1998	1201994	663179	421211	360150	220274	219045	216800	211361	142868	131802

Source: China Statistical Handbook 1999, China Statistical Information Network (1999)

Figure 13: Top 10 FDI Receiving Provinces in China, 1998 (%)



Source: China Statistical Handbook 1999, China Statistical Information Network (1999)

2.5.5 Regional Distribution of FDI to China

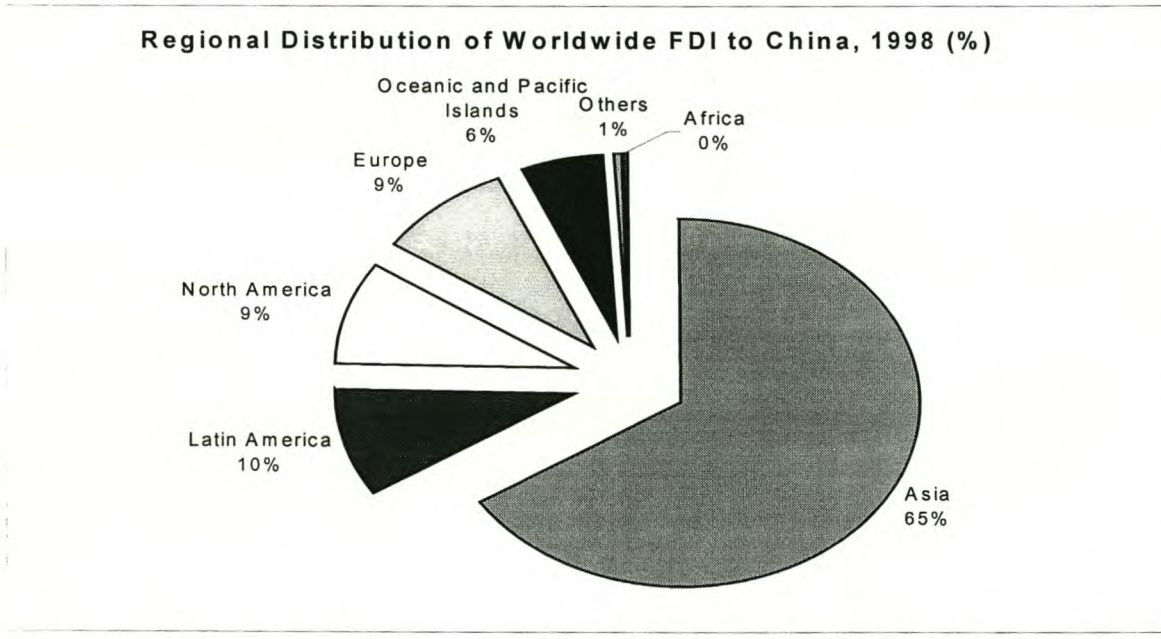
As illustrated in Table 2 and Figure 14, Asian countries were responsible for US$ 31.33 billion FDI to China, 68.92% of all the FDI to China in 1998. Followed by Latin- and North American countries and Europe.

Table 2: Regional Distribution of World-wide FDI to China, 1998

US$ 10 000	1997	1998	1998
Country (Territory)	Foreign Direct Investment	Foreign Direct Investment	% of World Total FDI to China
World Total	**4,525,704**	**4,546,275**	100.00
Asia	3,427,589	3,133,102	68.92
Latin America	198,139	456,213	10.03
North America	368,816	432,943	9.52
Europe	443,899	430,933	9.48
Oceanic and Pacific Islands	58,619	266,528	5.86
Others	20,405	23,839	0.52
Africa	8,237	15,876	0.35

Source: China Statistical Handbook 1999, China Statistical Information Network (1999)

Figure 14: Regional Distribution of Worldwide FDI to China, 1998



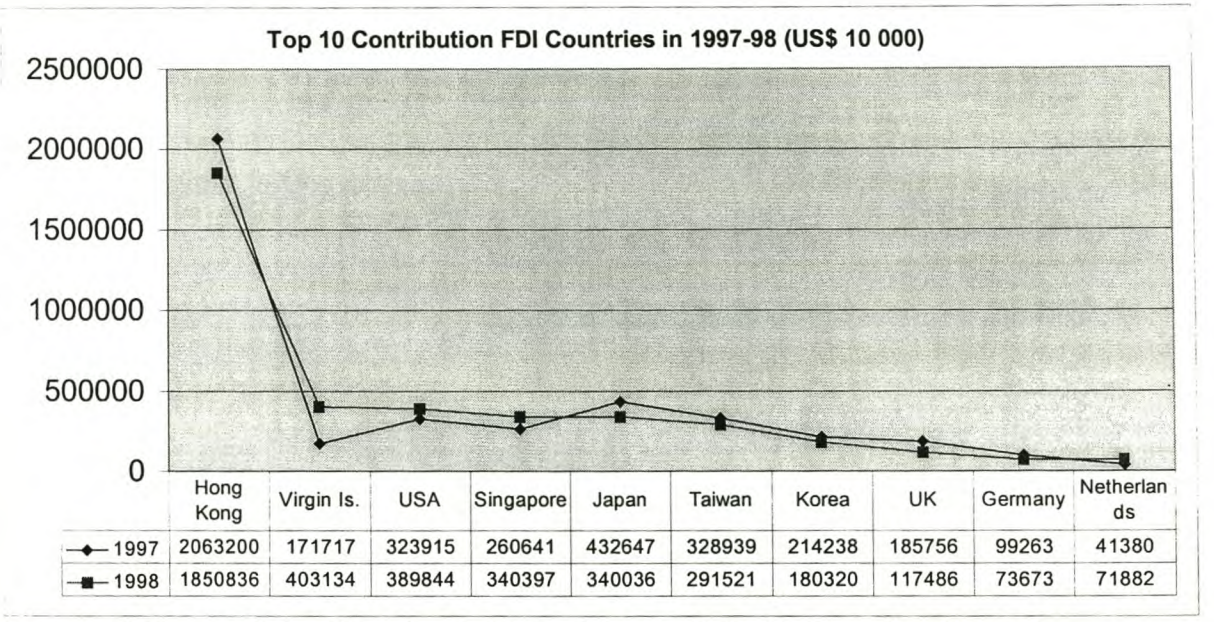
Source: China Statistical Handbook 1999, China Statistical Information Network (1999)

2.6.6 Country Distribution of FDI to China

Although most of the world's FDI to China come from other Asian countries, who is the major FDI contributor? Based on FDI levels of 1998, Figure 15 indicates the major role players in order of importance. First, with a FDI level of US$ 20.6 billion, is Hong Kong. A surprising second place belongs to the Virgin Islands, who channelled US$ 403.13 million FDI to China in 1998. Thirdly, the United States invested US$ 389.84 million in China. The high level of

FDI from the Virgin Islands may be contributed to the fact that the foreign investors invest via the Virgin Islands, as is the case with Hong Kong.

Figure 15: Top Contributing FDI Countries, 1997-1998



	Hong Kong	Virgin Is.	USA	Singapore	Japan	Taiwan	Korea	UK	Germany	Netherlands
1997	2063200	171717	323915	260641	432647	328939	214238	185756	99263	41380
1998	1850836	403134	389844	340397	340036	291521	180320	117486	73673	71882

Source: China Statistical Handbook 1999, China Statistical Information Network

The importance of key Asian FDI role players is also confirmed. Especially those of Hong Kong, Singapore, Japan, Taiwan and Korea. To further explore the importance of the 65 % of FDI to China refer Table 3 and Figure 16.

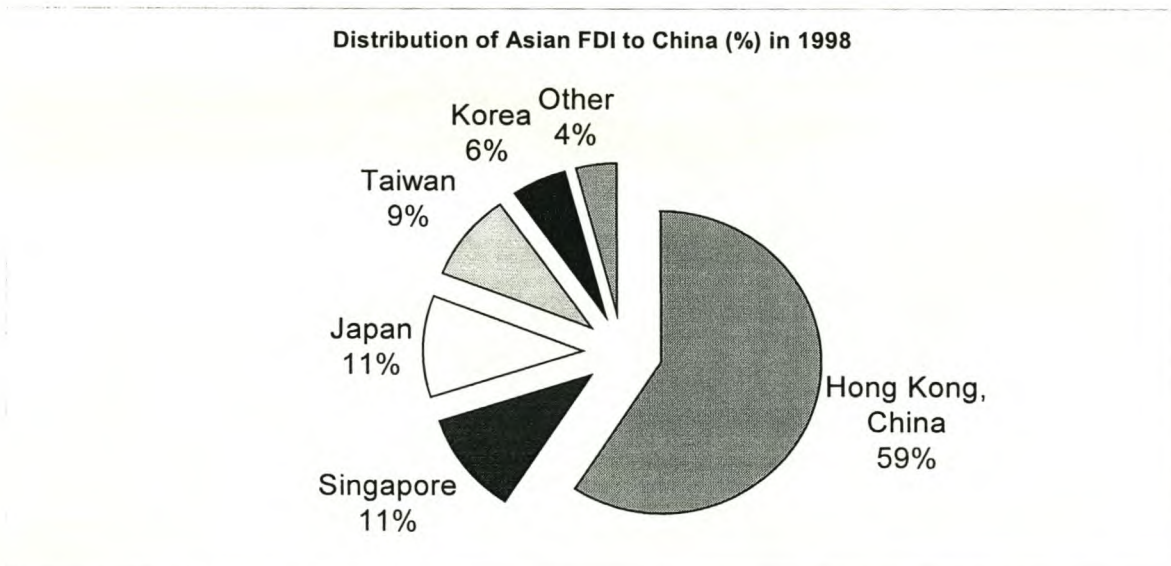
Hong Kong's contribution to the US$ 31.3 billion actual FDI to China amounts to 59 %. Singapore and Japan only managed 10.85 % and 10.86 % respectively. The question that should be asked what is does the FDI from Hong Kong consists of? What percentage of the Hong Kong FDI is actually from investors within China who 'round-trip' their investment to benefit from incentives given to foreign investors? This question however is beyond the scope of this thesis.

Table 3 : Top 10 Asian FDI Countries between 1997-1998

	US$ 10 000	1997	1998	1998
	Country (Territory)	Foreign Direct Investment	Foreign Direct Investment	% Asia FDI to China
	Total	**4525704**	**4546275**	
Nr.	**Asia**	**3427589**	**3133102**	
1	Hong Kong, China	2063200	1850836	59.07
2	Singapore	260641	340397	10.86
3	Japan	432647	340036	10.85
4	Taiwan	328939	291521	9.30
5	Republic of Korea	214238	180320	5.76
6	Macao	39455	42157	1.35
7	Malaysia	38183	34049	1.09
8	Thailand	19400	20538	0.66
9	Philippines	15563	17927	0.57
10	Indonesia	7998	6897	0.22

Source: China Statistical Handbook 1999, China Statistical Information Network

Figure 16: Distribution of Asian Actual FDI to China in 1998



Source: China Statistical Handbook 1999, China Statistical Information Network

2.6 Impact of Foreign Direct Investment on the Chinese Economy

Foreign direct investment can affect a host country on both macro- and micro levels. On a micro level, areas that can be affected include transfer of technology, knowledge and best

management practices. Host countries can also gain access to world markets by allowing foreign invested enterprises.

On a Macro Level, real macro-economic variables like domestic investment, economic growth, employment, imports and exports may be affected. Financial variables such as interest rates, foreign exchange rates, inflation levels and balance of payments can be affected. (Sun: 1998)

2.7 Summary

Through the market reforms of Deng Xiaopeng and Zhu Rongji, China has been gradually opened to the foreign investor since 1978. A phased approach for the opening of the market was employed by first only allowing investment in the special economic zone while only the CJV could be utilised as an entry vehicle for foreign investors. Reforms in state enterprise created opportunities for foreign investors to exploit opportunities in the state sectors. In addition the development of a legal framework and policies for attracting foreign investment resulted an explosion of foreign direct investment since 1991.

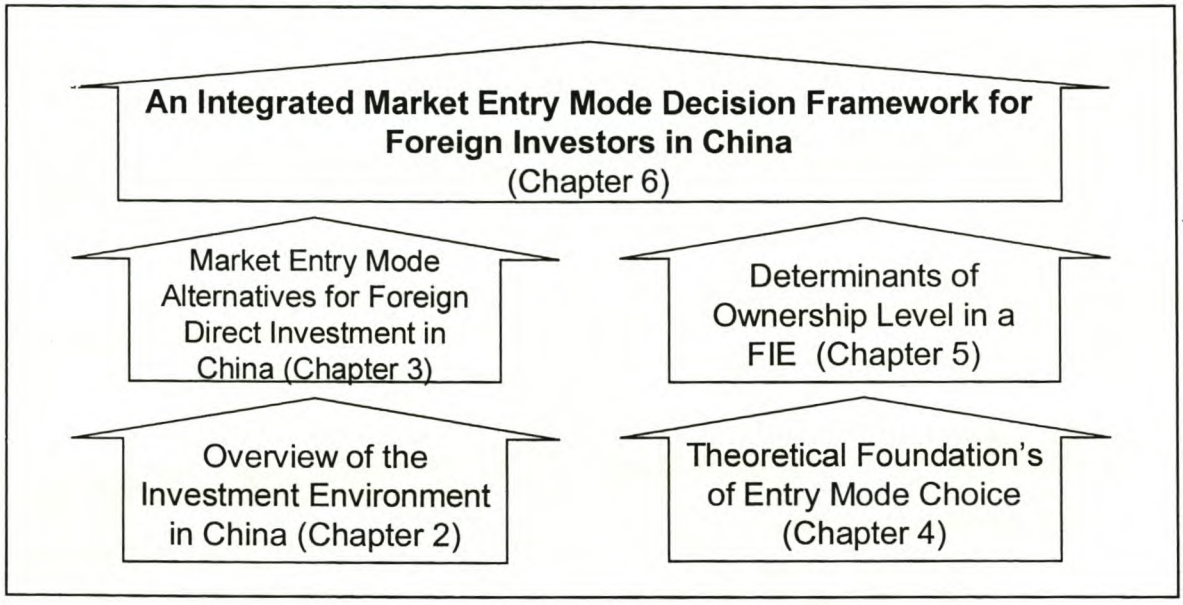
FDI to China over the past ten years was characterised by structural changes in the size-, location-, and sectors of FDI to China. Most notable is the changes in entry modes utilised to enter China. Although EJV's reigned as the supreme entry vehicle, since 1994 the WFOE became a major entry vehicle, and by 1999 the WFOE was just as an important entry vehicle as the EJV. The CJV lagged behind in the third place, while the JSLC only emergence as a fourth alternative. The importance of each of these entry vehicles will be discussed in the next chapter.

3 Market Entry Mode Alternatives for Foreign Direct Investment in China

3.1 Introduction

While chapter 2 provided a foundational overview of the history, trends and reforms of foreign direct investment in China, chapter 3 will need to answer one of the most critical questions for the foreign investors (see Figure 17). Which entry modes or -vehicles are available for the foreign investor in China? What are the advantages, disadvantages or problems of each entry mode? And which of these is the better performing entry mode in China?

Figure 17: Market Entry Mode Decision Building Block Two



3.2 Overview of Market Entry Modes

Four broad categories of market entry modes available to the foreign investor can be identified in Figure 18: exporting, foreign indirect investment, foreign contractual investment, and foreign portfolio investment. As indicated with the grey scale in the figure, the focus of this thesis will be on evaluating foreign direct investment entry modes (Czinkot & Ronkainen: 1998; Kotabe & Helsen: 1998; Chee & Harris: 1998; Mead: 1998)

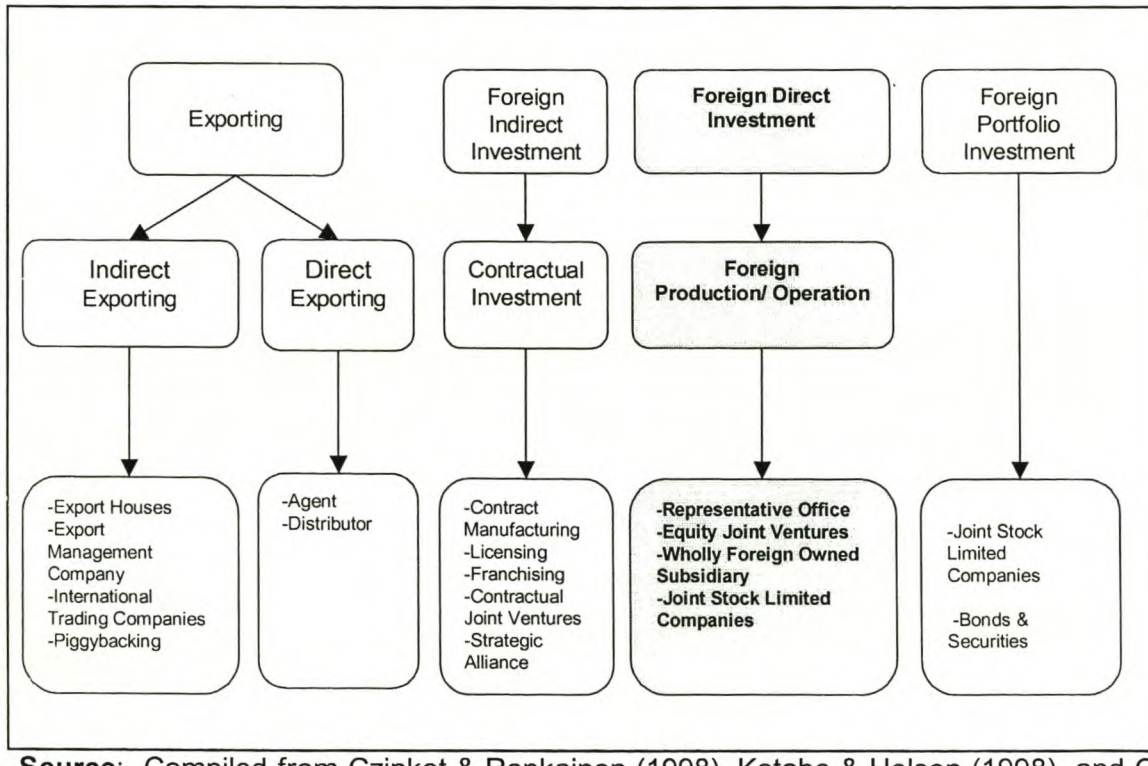
3.2.1 Exporting

Exporting can be subdivided into indirect- and direct exporting. Indirect exporting may include the utilising of export houses, export merchants, confirming houses, export agencies, export management companies, international trading companies, joint marketing or piggyback exporting and overseas buying offices (Chee & Harris: 1998; Kotabe & Helsen: 1998). Direct exporting instruments comprise the use of agents, distributors and the creation of overseas sales branch offices. A main feature of exporting is that the actual production of the product is still generated in the home country.

3.2.2 Foreign Contractual Investment

Although foreign contractual investment incorporates various forms of licensing, franchising, contract manufacturing and contractual joint ventures, here follows just a brief reference to licensing and joint ventures.

Figure 18: Market Entry Modes Alternatives for China



Source: Compiled from Czinkot & Ronkainen (1998), Kotabe & Helsen (1998), and Chee & Harris (1998)

3.2.2.1 Licensing

Licensing is a contractual transaction where the licensor offers some proprietary assets to a foreign company – the licensee – in exchange for royalty fees. The main advantage of licensing is the relatively easy way in which to enter a foreign market with scant resources, and allows the investor to navigate around import barriers in the host country. It is well suited for smaller companies. Licensing however can be less profitable than joint ventures and WFOE's. Lack of commitment to the product from the licensee may result in weak performance. After absorbing the technology, the licensee may mature into a competitor (Kotabe & Helsen: 1998). Two specialised types of licensing include contract manufacturing and franchising.

3.2.2.2 Contractual Joint Venture

Business-China (1999) describes a Sino-foreign contractual joint venture (CJV): 'A CJV is formed by signing a contract through consultation of concerned parties from China and other countries or regions. The contract shall define clearly the rights, obligations and interest distribution to each party. The different contributions of each party of a co-operative venture do not have to be in the form of equities, and the share of profits, losses and risks are all stipulated in the contract. It is a contractual co-operative enterprise' (http://www.business-china.com/invest/guide.htm#form.htm).

The 1978 Sino-Foreign Co-operative Contractual Joint Venture Law governs CJV's. Since the law lacks detailed implementation regulations, CJV's have wide discretion to organise and manage its operations. No minimum contribution or limits on the term or scope of contract is provided. No prohibitions for withdrawal from the contract are stipulated. CJV is quick to establish and quick to terminate, and therefore especially attractive and suitable for shorter-term projects like property development. However due to the deficiency of regulations, CJV's are often at the mercy of local authorities' interpretation of an acceptable scope of business. Since this investment vehicle is perceived by the authorities to be short term in nature it is difficult to procure materials, obtain financing or qualify for tax benefits (Brecher: 1995).

3.2.3 Foreign Portfolio Investment

Foreign Portfolio Investment involves the purchasing of stocks and bonds internationally. It is primarily a concern to the international financial community (Czinkot & Ronkainen: 1998: 439). The joint stock limited company in China can be used either for portfolio investment or direct investment, depending whether the investment is of long term nature or not.

3.2.4 Foreign Direct Investment

Chapter 2 pointed out foreign direct investment involves a long-term relationship reflecting investors' lasting interest in a foreign entity (UNCTAD(c): 1999). The focus of this thesis will be on reviewing market entry mode decisions in the context of foreign direct investment market entry vehicles. The residue of chapter 3 will review the following direct investment entry modes: representative office; equity joint venture; wholly foreign-owned enterprise and joint stock limited company.

3.3 Representative Office

3.3.1 Description

The representative office is by far the most common foreign business form in China (Melvin: 1997). Rothstein (1996) suggests that a representative office is one of the easiest and most efficient ways of establishing a presence in China. Zhu (2000) propounds that foreign investors frequently use representative offices, especially in the early stages of investment. Todd (1998) advises companies analysing the market entry decision to consider establishing a representative office in China without spending much money.

Before a foreign entity attempts to buy or sell products in China, it should establish a RO to foster business contacts, investigate JV partners, and perform market research (Hafter & Sullivan: 1997). The Puget Sound Business Journal (1996) defines a RO as an office that engages in activities that are not direct business operations. An office limited to consultation, market research, contacting prospective customers, negotiations on behalf of the head office and contract administration. It is not permitted to make profit. The Business-China (1999) quoting state regulations confirms, 'activities of established institutions (RO's) can only be within the range of business connection, products introduction, marketing, technology exchange and consulting services' (http://www.business-china.com/invest/guide.htm#form.htm). Todd (1998) explains, to establish a RO, the RO enters into a service agreement with parent company to provide defined services in China. For example co-ordination, liaison, promotion, market surveys and other services on behalf of the parent company.

The RO is required by law to open a bank account, employ locals and promote the company name or establish basic operations (Hafter & Sullivan: 1997). A RO also enables a foreign entity to install telecom lines, buy equipment or obtain visas for visitors (Puget Sound Business Journal: 1996).

A RO is not a separate legal entity, but part of the foreign corporation. The chief representative is the designated agent for the foreign entity (Puget Sound Business Journal: 1996).

3.3.2 Advantages of Representative Offices

A representative office is a simple and flexible vehicle with a relatively low set-up- and operating cost. Whereas many restrictions exist in industries where WFOE's and EJV's may operate, no such restriction exists for representative offices (Rothstein: 1996). A RO can be set-up in less than six months (Puget Sound Business Journal: 1996). In most cases it is easy to attract personnel. Young Chinese graduates are very willing to work for representative offices since it gives them exposure to the multinational environment (Rothstein: 1996). By setting up a RO it gives an all important first impression to prospective partners and customers qualifying the establishment, maintenance of long term relationships and soliciting of sales on behalf of head office (Puget Sound Business Journal: 1996).

3.3.3 Disadvantages of Representative Offices

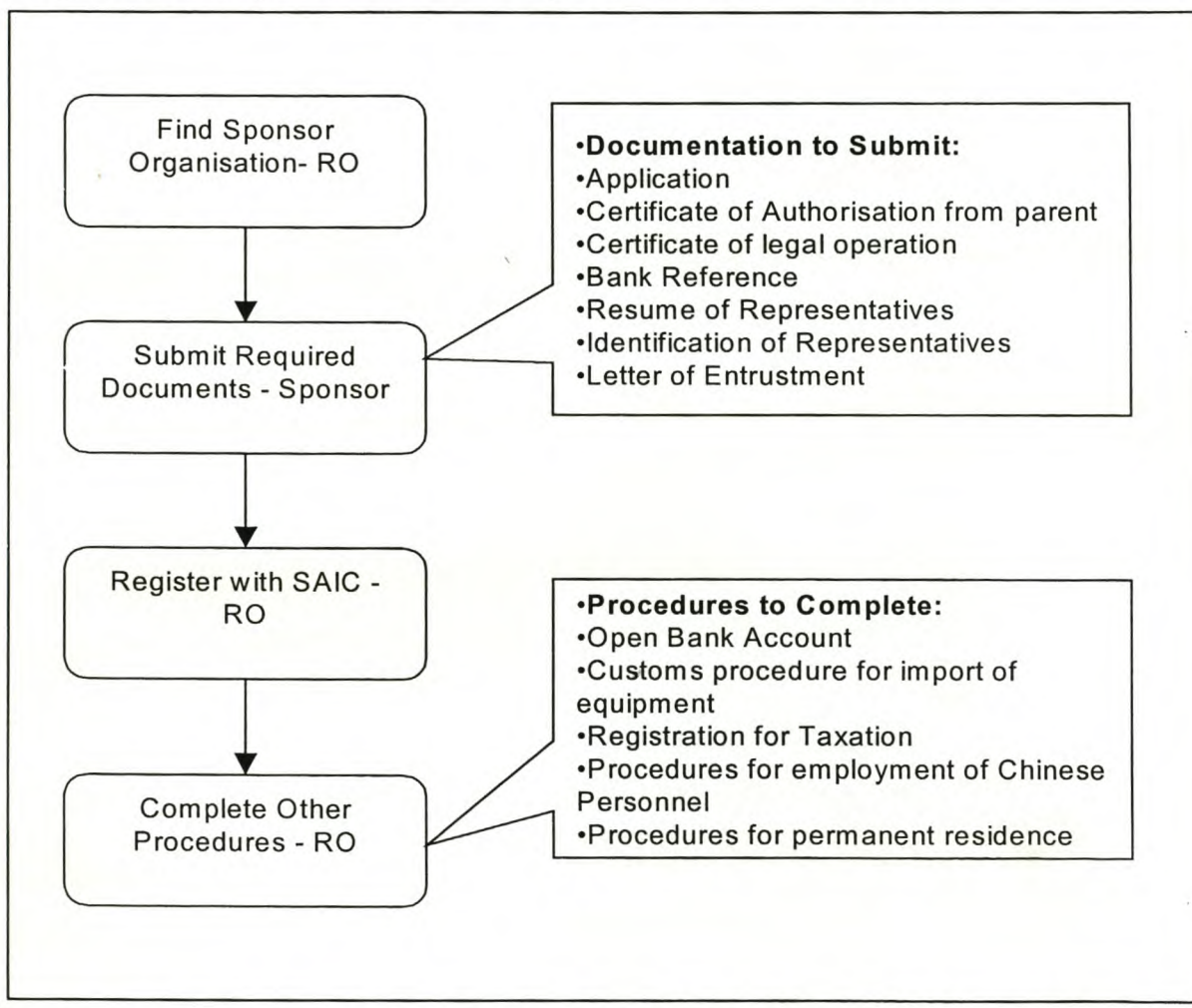
Rothstein (1996) highlights the prohibition of direct profit making activities and the fact that the representative office is taxed, as the handicap of representative offices. If a RO goes beyond its permissible activities, it will be taxed at the 33% company tax, and a 5% business tax on its gross receipts. The law also requires a taxable RO to earn an arms-length profit based on the functions it perform (Todd: 1998). A further obstacle is that RO's must recruit their personnel through state management companies (Rothstein: 1996).

3.3.4 Procedure for Setting up an Representative Office

Figure 19 shows a simplified process of setting up a representative office. First the applicant must find a sponsor for the application. The sponsor may vary depending on the industry. Often it can be the Bank of China or the Ministry of Foreign Trade and Economic Co-operation (MOFTEC). The applicant will then submit the required documentation to the sponsor who in turn presents it to the authorities for approval. 'Within 30 days of receiving

the letter of approval, the applicant must present the local bureau of the State Administration of Industry and Commerce (SAIC) with 600 yuan ($73) and six documents: the approval letter issued by the approval authority, the company's certificate of in-corporation from the home country, an application letter signed by the company chairman, a capital credibility certificate, a brief resume of each of the representatives, and a SAIC application form completed in Chinese and English. If all the documentation is in order, SAIC will issue an office registration certificate and a representative office certificate, both of which are valid for one year. The applicant must also register with the Public Security Bureau, PRC Customs, and the State Administration of Taxation, each of which has its own documentation requirements' (Rothstein: 1996: 31).

Figure 19: Set-up Procedures of a Representative Office in China



Source: Compiled from Business-China (2000), Sheila (1997), Rothstein (1996) and Puget Sound Business Journal (1996)

3.3.5 Suggestions

Rothstein (1996) concludes that many big companies have utilised RO's as a means of low risk entering. Some have spent years courting government officials through the presence of a representative office before it plunged into a joint venture or WFOE. Some continue to utilise a RO as the head office.

3.4 Equity Joint Venture

3.4.1 Description

'An equity joint venture is a venture in which each party's contribution is decided through consultation and clearly defined in the contract. The venture shall be jointly invested, jointly managed, and the parties shall share its risks, profits and losses. Generally, the ratio of foreign investment to total registered capital shall not be less than 25 %. Each party's investment can be in cash or in the form of premises, factory building, equipment, machinery or other materials, industrial property, patented technology and right to land use. A Chinese-foreign joint venture is a limited enterprise of share ownership with the status of legal person.' (http://www.business-china.com/invest/guide.htm#form.htm).

EJV's are governed by the 1979 law of China on joint ventures using Chinese and foreign investment and the July 1979 implementing regulations issued in September 1983 (Brecher: 1995). Brecher (1995) explains that if an EJV is dissolved its profits, losses and assets are distributed according to each partner's holding in the registered capital. A foreign company must own at least 25% stake in an EJV.

3.4.2 Forms of Equity Joint Ventures

Equity joint ventures can be differentiated by the amount of equity that the foreign partner holds: Majority equity stake, 50-50 or minority equity stake (Kotabe & Helsen: 1998). Chee & Harris (1998) suggests that joint ventures can also be classified in the following way:

Spider's web strategy: Establishing a joint venture with a large competitor and avoiding absorption through joint ventures with others in network.

Go-together then split strategy: Co-operate over an extended period of time and then separate. Suitable for construction type projects.

Successive integration strategy: Starts with a weak inter-firm linkage, and gradually moves towards interdependence and finally towards a merger or acquisition.

3.4.3 Advantages of Equity Joint Ventures

Although joint ventures are often seen as a forced entry strategy due to government regulations, a number of good reasons exist for entering into a joint venture (Czinkot & Ronkainen: 1998; Kotabe & Helsen: 1998; Chee & Harris: 1998; Mead: 1998). Joint ventures yield higher control and returns than a licensing strategy. A major reason why foreign investors opt for a JV entry is to gain strategic access to markets through the JV Partner. If a credible partner is found it can provide valuable market experience and knowledge. In addition to market knowledge, partners, if chosen correctly, might bring about contacts with government, suppliers and customers critical to success. The pooling of resources reduces risks and the cost of doing business in a foreign country. If well matched, the combination of skills, technology and know-how can create synergy between the partners. As with licensing, joint ventures can overcome export restrictions to the host country. Joint ventures often receive special incentives and tax breaks from the government. Governments fear the loss of control of the economy and seek the transfer of technology and managerial skills from the foreign investor. In return the government might grant preferential treatment. Chee & Harris (1998) suggest that joint ventures are very useful in oligopolistic market where it will be too expensive to directly oppose the few strong incumbents.

3.4.4 Disadvantages of Equity Joint Ventures

The biggest drawback of EJV's from the foreign investor's perspective is the lack of full control (Czinkot & Ronkainen: 1998; Kotabe & Helsen: 1998; Chee & Harris: 1998; Mead: 1998).

3.4.4.1 Non-Performing Partners

Wong & Maher, et. al. (1999) suggest that in China partner-related problems are most significant. Chinese partners want to dominate foreign partners. The partner often has a political agenda. Often the partner's contributions dwindle over the years, both in resources commitment and actual management involvement. In addition JV partners have not lived up to expectations: the partner did not provide the expected market knowledge and had limited connections, or did not have the correct connections.

3.4.4.2 Divergent Motivations

Kotabe & Helsen (1998) points to the conflicting objectives between Chinese and foreign joint venture partners from Martinson & Tsong (1995) in Table 4.

Conflicts may arise from matters such as strategy, allocation of resources, technology, brand names and often taking of profits (Kotabe & Helsen: 1998). Chinese partners also seek profits on a shorter time horizon, and different opinions on profit taking are the source of many conflicts between foreign and Chinese partners (Vanhonacker: 1997).

Table 4: Conflicting Objectives in Chinese Joint Ventures

	Foreign Partner	Chinese Partner
Planning	Retain business flexibility	Maintain congruency between the ventures an the state economic plan
Contracts	Unambiguous, detailed and enforceable	Ambiguous, brief and adaptable
Negotiations	Sequential, issue by issue	Holistic and heuristic
Staffing	Maximise productivity; fewest people per given output level	Employ maximum number of local people
Technology	Match technical sophistication to the organisation and its environment	Gain access to the most advanced technology as quickly as possible
Profits	Maximise in the long term; repatriate over time	Reinvest for future modernisation; maintain foreign exchange reserves
Inputs	Minimise unpredictability and poor quality of supplies	Promote domestic souring
Process	Stress high quality	Stress high quantity
Outputs	Access and develop domestic market	Export to generate foreign currency
Control	Reduce political and economic controls on decision-making	Accept technology and capital but preclude foreign authority infringement on sovereignty and ideology

Source: Martinson & Tsong (1995: 5)

3.4.4.3 Technology Leakage or Slipover

A major concern especially in China with its very weak intellectual property protection is the problem of technology leakage to the joint venture partner. Vanhonacker (1997) warns that most Chinese companies lack experience to keep up with technological innovation. Such partners also lust for the technology of foreign partners and foreign parties should therefore be on their guard against copying of their technology or technology spill over. Many cases exist where partners have divulged trade secrets and technology to suppliers, customers or even competitors (Potter & Oksenberg: 1999; Gelb: 2000).

3.4.4.4 Employee Problems

Government policies of assigning and rotating managers give rise to the obvious problems of short-term view and lack of skills. As soon as a manager is properly trained, he or she must make room for the new assignee. Adding to the cost of joint ventures, is the tendency of overstaffing JV's with poorly educated workers. Employee loyalty as a rule, is not highly

valued. Former SOE workers fear mistakes and penalties and seldom take initiative. Workers lack hands on experience with machinery and have no intrinsic value for machine maintenance (Wong & Maher, et. al.:1999).

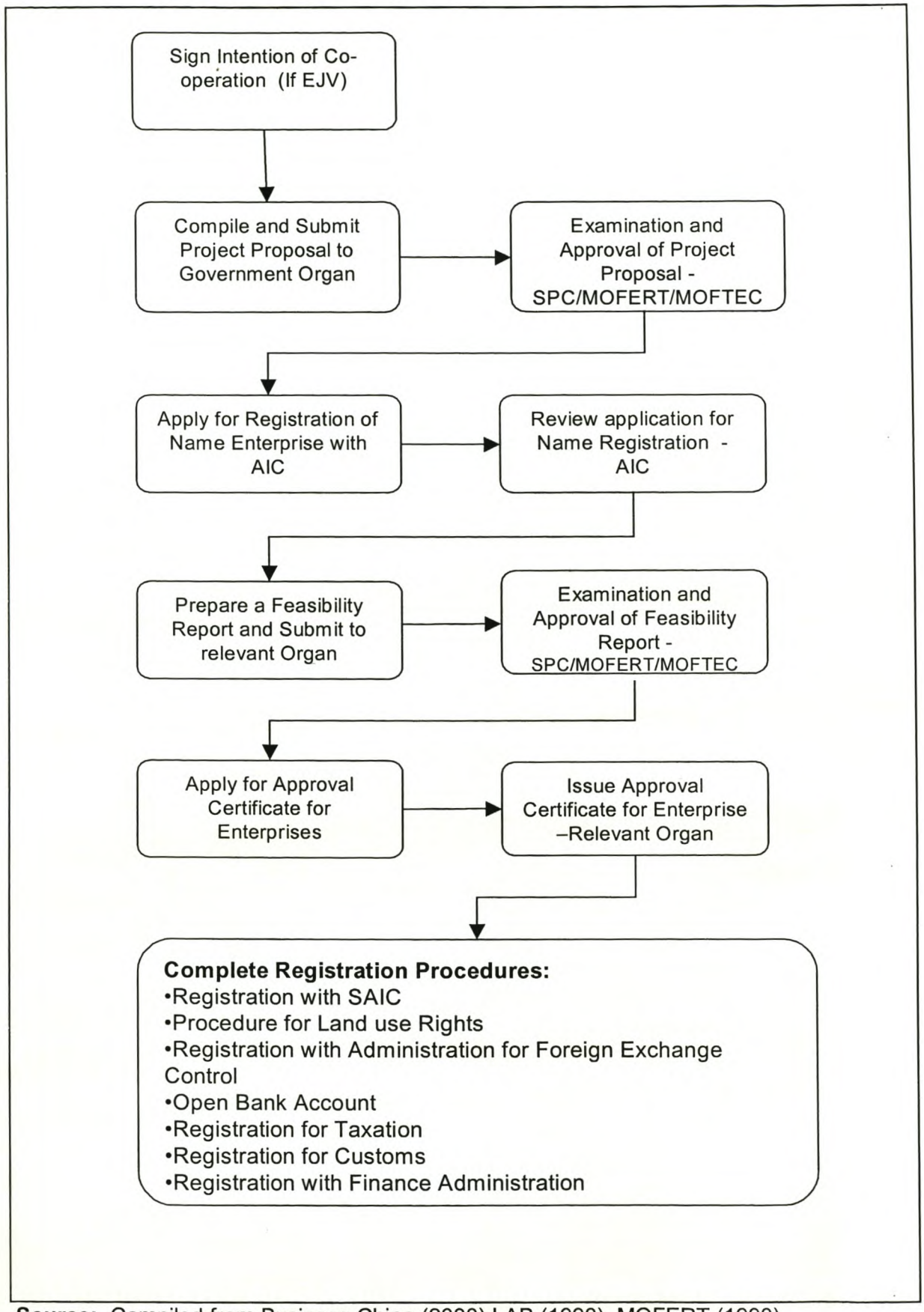
3.4.5 Procedures for Establishing Enterprises with Foreign Investment

To establish an EJV the simplified procedure as illustrated in Figure 20 can be followed. After preliminary talks the partners/ investors will sign a letter of intent and draw up a project proposal that will be submitted by the Chinese partner to the appropriate government organ. Depending on the value of the investment, it will be submitted either to the State Council, State Planning Commission or the Local Planning Commission. The pertinent departments will review and approve/ reject the proposal. Upon approving the proposal the investors may apply for registration of the enterprise's name at the appropriate Administration of Industry and Commerce. A possibility (feasibility) study report will be prepared and submitted to the appropriate body for approval. The articles of association and the contract of the EJV and the CJV will be reviewed and approved/ rejected by MOFERT at every government level. Upon approval of the articles and contract the investors may apply for an approval certificate to establish an enterprise with foreign investment. Upon receiving the certificate the investors may continue with the rest of the registration procedures as highlighted in Figure 20.

3.4.6 Recommendations for Foreign Joint Venture Managers in China

Wong & Maher, et. al., (1999) recommend that foreign investors should calculate the costs of doing business in China. It will take an average 10 years to realise profits. Undue attention from authorities should be avoided. If possible locate in a smaller municipality and make smaller investments. Acquire 50-75 % ownership and for similar reasons obtain majority membership on the board of directors. Establish individual sales and distribution system. Use older technology to avoid technology leakage and keep suppliers close to head office; suppliers need to be monitored. Apply western human resource strategies: for example arrange people in work teams, draw up job profiles, base remuneration on merit, institute a five day work, sliding holidays. Wong & Maher, et. al., (1999) further suggest that younger people should be recruited since the bad state worker mentality has not yet been reformed. Scholarship is a powerful motivator for the younger Chinese employees.

Figure 20: Set-up Procedure for Foreign Invested Enterprise



Source: Compiled from Business-China (2000),LAB (1990), MOFERT (1990)

Kotabe & Helsen (1998) suggest that to be successful in a joint venture, the first step would be to pick the right partner, and establish clear objectives from the beginning. A 'china man' (someone who knows both cultures and languages) to bridge cultural gaps will be useful. Commitment from top management is argued to be essential for success, while an incremental approach to implementation is advocated.

3.5 Wholly Foreign-Owned Enterprise

3.5.1 Description

A Chinese wholly foreign-owned enterprise refers 'to enterprises in China established by foreign companies, enterprises, economic organisations or individuals with funds entirely of their own. They are also called enterprises exclusively run with foreign funds. All the profits made by a foreign enterprise goes to the foreign investors'. (http://www.business-china.com/invest/guide.htm#form.htm)

The 1986 Law of the PRC Concerning Enterprises with Sole Foreign Investment, and detailed implementing regulations issued in 1990, governs the WFOE. A WFOE is solely owned and operated by the foreign investor, it may or may not have legal person, and it may or may not be organised as a limited liability company. Furthermore it receives all the profit and bears all the risks. The advantage of a WFOE is a greater control over the enterprise by the foreign investor and the fact that it can make unilateral decisions without the regards of a Chinese partner. A WFOE is protected against constraints of redundant labour and excessive demands for technology transfer from a Chinese partner (Brecher: 1995).

3.5.2 Advantages of Wholly Foreign-Owned Enterprise

Vanhonacker (1997) advocates that WFOE's should be considered as a preferred alternative to EJV's. He explains that WFOE's and EJV's are essentially the same in terms of taxation and corporate liability, while the only real difference is that WFOE's take less time to establish than EJV's, a board of directors are not required, and WFOE's are more restricted that EJV's in certain sectors.

Vanhonacker (1997) advances that WFOE's are on the increase because FIE's have become frustrated with inferior performance and limitations of EJV's. In addition companies

have met little opposition from government in establishing WFOE's. Some of the major advantages of WFOE's above that of EJV's are the following:

Flexibility and managerial control: companies can control their own internal operations and procedures. They are not limited by lengthy decisions making processes of involving the Chinese partners.
Faster to establish: local authorities are required to respond within 30 days for a WFOE's application. An EJV may take years to negotiate.
Efficiency and effectiveness: WFOE's are in control of their own operations. It can deliver efficiency and effectiveness equal to their home countries, and are not limited by the economic structure of the Chinese partner.

3.5.3 Disadvantages of Wholly Foreign-Owned Enterprise

Although greater control can be obtained through more ownership, it comes with a higher risk and cost. WFOE's do not have the benefit of a Chinese partner's experience and access to the market, and therefore risk making expensive mistakes.

As can be seen in the gradual adoption of WFOE's over years, it seems that foreign investors should consider WFOE's only when they are already experienced role players. They should be confident that sufficient financial and knowledge capital is available to utilise such a high control/ resources commitment entry vehicle.

3.5.4 Set-up Procedures of Wholly Foreign-Owned Enterprise

Set-up procedures of WFOE's are very similar to that of joint ventures (See Figure 20). The only difference being that no local partner is involved in the process.

3.6 Joint Stock Limited Companies

Capener (1998) in his article 'A New Investment Vehicle', refers to the adoption of the joint stock limited company by the 15th Party Congress of the PRC. The congress decided that joint stock limited companies, as the preferred state asset vehicle should replace all SOE's. Joint stock limited companies are governed by the 1994 company law as well as the provisional regulations on several issues concerning the establishment of joint stock limited companies with foreign investment in January 1995. These provisions created a new vehicle for Sino-foreign investment. A company can be established by 'sponsorship' or 'share offer'.

It is possible to establish a foreign invested joint stock limited company as the acquiring entity. One of the first examples of a Sino-foreign JSLC is Eastman Kodak, which formed a JSLC with two other SOE's in the photographic industry.

Smyth (1998) describes reforms of SOE's. Large and medium sized enterprises (LMEs) are converted into joint stock companies or limited liability companies in which each shareholders liability is proportionate to the investment. Better performing LMEs are listed on the Shanghai, Shenzhen, Hong Kong or New York stock exchange, where shares are divided in different classes. A-shares are reserved for domestic investors and denominated in renminbi and B-shares are restricted to foreigners and denominated in U.S dollars (see chapter 2).

Sinopec, China's petrochemical giant provides an example of how foreign investors can strategically utilise the JSLC vehicle. Sinopec was due for listing on the Hong Kong and New York Stock exchanges in a multi-billion initial public offering. 95% of the shares were purchased by strategic investors in the petrochemical industry, namely Exxon Mobil, BP Amoco and Royal Dutch Shell (Euroweek: 2000).

3.7 Laws Governing Foreign Investment in China

The 1979 Law of the PRC on Joint Ventures Using Chinese and Foreign Investment was the first law promulgated in China allowing foreign investment. Table 5 indicates the development of the legal framework that governs foreign Investment in China. Increasing foreign investment levels and greater experience with foreign investors gave rise to the steady development of a legal framework, guiding and governing foreign investment in China.

Table 5: Law's Governing Foreign Investment in China

Law	Date Promulgated	Drafting Agency
Law of the PRC on Joint ventures using Chinese and Foreign Investment amended in April 1990	**July 1979 implementing regulations issued in September 1983**	State Council
Regulations of the PRC on Labour Management in Joint Ventures Using Chinese and Foreign Investment	July 1980 implementing regulations issued in January 1984	Ministry of Labour
Provisional Regulations for Exchange Control of the PRC	December 1980	State Council
Rules for the Implementation of Exchange Control Regulations Relating to Enterprises with Overseas Chinese Capital Enterprises with Foreign Capital and Sino-Foreign Joint ventures	August 1983	State Administration of Exchange Control (SAEC)
Provisions of the State Council on the Question of the Balancing of Foreign Exchange Receipts and Expenditures of Sino-Foreign Joint Ventures	January 1986	State Council
Provisions of the State Council for the Encouragement of Foreign Investment ("The 22 Articles")	October 1986 implementing regulations issued in 1986-87	State Council
Law of the PRC Concerning Enterprises with Sole Foreign Investment (WFOEs)	**April 1986 implementing regulations issued in December 1990**	**MOFTEC**
Provisional Regulations of the State Administration for Industry and Commerce on the Ratio of Registered Capital to Total Investment of Sino-Foreign Joint ventures	March 1987	State Administration of Industry and Commerce (SAIC)
Certain Provisions on Capital Contributions by Parties to Sino-Foreign Joint Ventures	January 1988	Ministry of Foreign Trade and Economic Co-operation (MOFTEC) and SAIC
Sino-Foreign Co-operative Contractual Joint Venture Law	**April 1988**	**MOFTEC**
Foreign Investment Enterprise and Foreign Enterprise Unified Income Tax Law	April 1991 implementing regulations issued in June 1991	Ministry of Finance (MOF)
Opinion of Standards for Companies Limited by Shares	May 1992	State Economic Commission implementing agency is the State Commission for Restructuring the Economy
Value-added Tax Consumption Tax and Business Tax Regulations	November 1993	MOF
Company Law	December 1993	SAIC
Provisional Regulations on The Establishment of Foreign Funded Joint Stock Companies Limited	**January 1995**	**MOFTEC**

Source: Compiled from Brecher (1995: 10-18), MOFTEC: 1995)

3.8 Joint Venture vs. WFOE Performance in China

Although much can be speculated about the advantages and disadvantages of CJV's, EJV's and WFOE's in China, the foreign investor are concerned about the impact of entry mode on the profitability and market share of its venture.

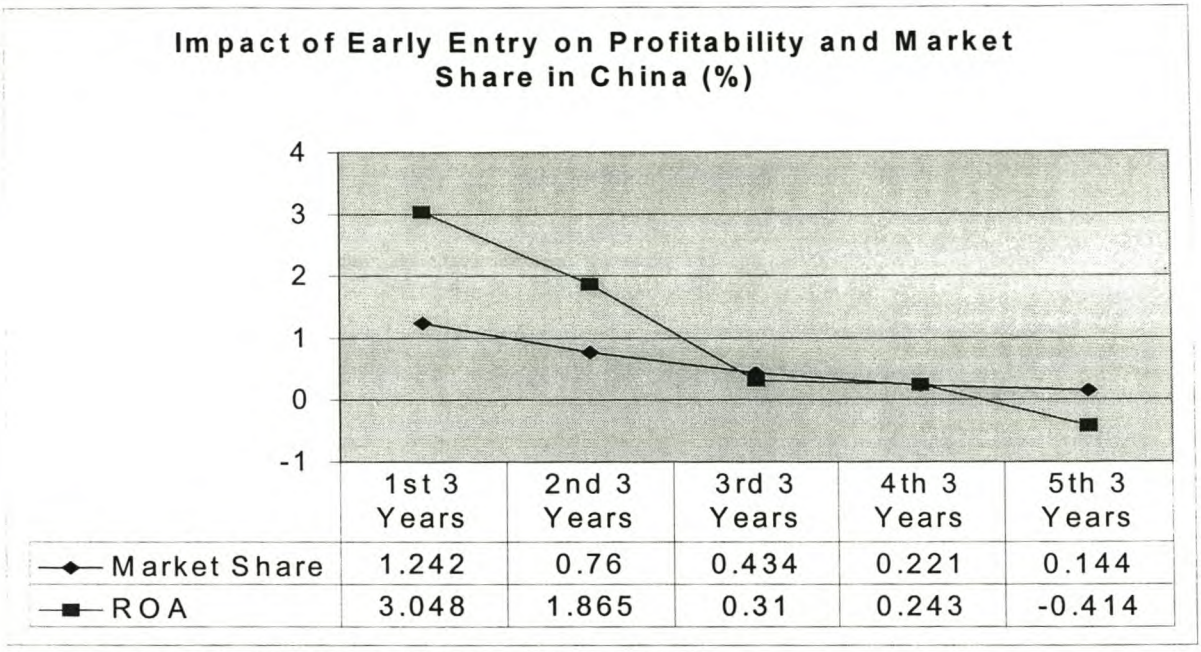
Pan, Li & Tse (1999) sampled 14466 foreign entrants in 610 product-classification in China. The impact of order and mode of market entry on profitability and market share were studied. The three modes of entry that have been evaluated were the CJV, EJV and WFOE in China. Although the main focus of this thesis relates to the mode of entry, for the purpose of this discussion order and lead-time of entry has a significant effect on profitability, and as a result entry mode's impact cannot be seen in isolation.

3.8.1 Order and Lead-Time of Market Entry

Pan, Li & Tse (1999: 84) found that 'foreign firms that are early entrants in a given product sector in a host country have higher market shares and profitability than those entering at a later time'. Figure 21 depicts the impact of early entry on profitability and market share in China. The average market share per entrant was 0.453% and the average return on assets (ROA) was 0.573%. Early entrants' market share had an average market share of 1.960, which is much higher than the average for all foreign firms. The average of 2.952% ROA is also much higher than the average of all the companies.

Figure 21 also illustrates that the 'the amount of lead-time for early entrants is positively related to market shares and profitability' (1999:84). Market share and profitability decreases the later foreign companies entered China.

Figure 21: Impact of Early Entry on Profitability and Market Share in China



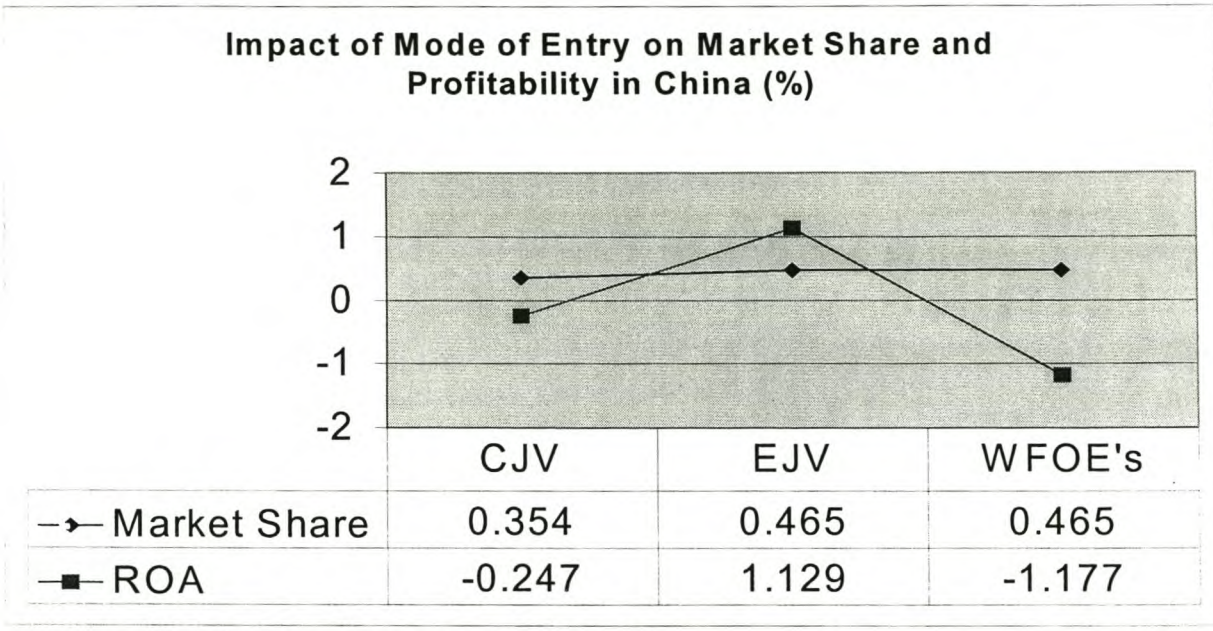
Source: Compiled from Pan, Li & Tse (1999: 85-86)

3.8.2 Impact of Market Entry Mode on Profitability and Market Share in China

With regards to the impact of market entry mode on profitability and market share in China Pan, Li & Tse (1999) hypothesised and confirmed that WFOE's and EJV's have higher profitability and market share than CJV's (see Figure 22). EJV's and WFOE's perform better than CJV in terms of market share, however with regards to profitability EJV performs much better than WFOE's. The reason for this might be that EJV's are usually found in pillar industries where profitability is higher. In addition the WFOE's take a long-term view and reinvest profits in order to obtain a long-term dominant market position.

Verifying earlier results Pan & Chi (1999: 359-374) studied 1 066 MNC's from Hong Kong, Taiwan, USA, Japan and Europe to establish the impact of entry mode on the profitability of foreign firms in China. They found that WFOE's do not have a higher return on sales than EJV's or CJV's, but EJV has higher return on sales than both WFOE's and CJV's.

Figure 22: Impact of Early Entry on Profitability and Market Share in China



Source: Compiled from Pan, Li & Tse (1999: 83-84)

Pan & Chi (1999) stress that entry mode choice matters. Foreign entrants need to take caution for the down side of entering China alone. Valuable advantages of an EJV like favourable government policy, easier procurement of supplies, concessions and market access can be lost when entering alone.

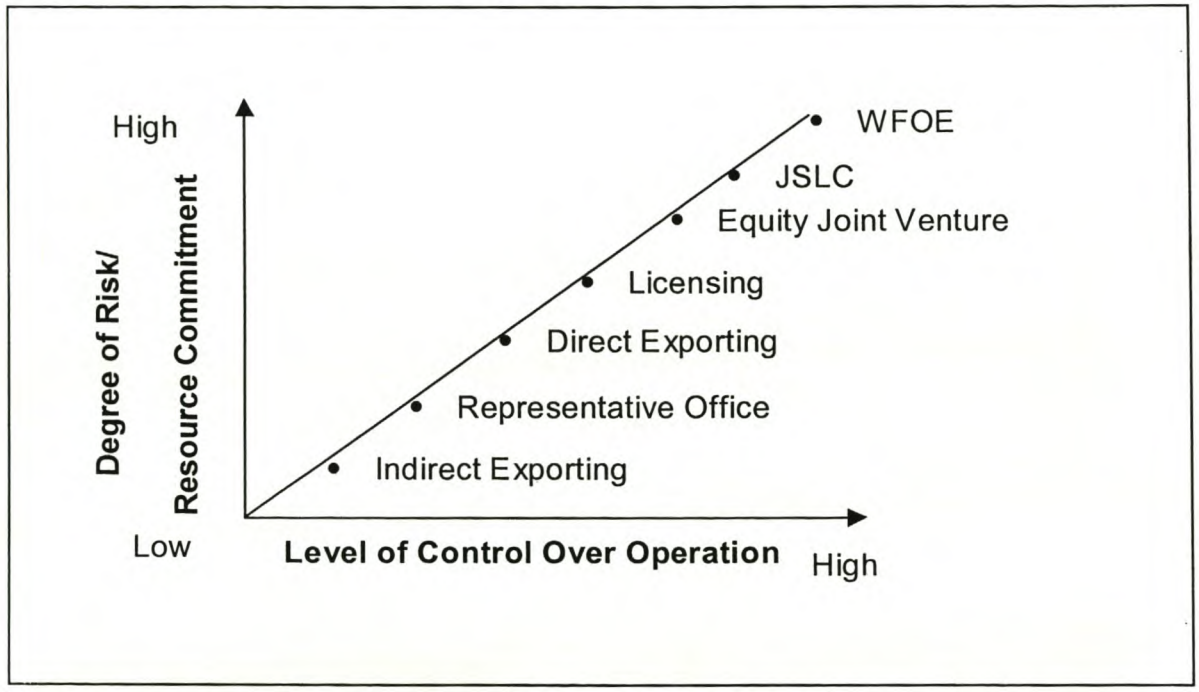
3.8.3 Interaction between Order and Mode of Market Entry

Pan, Li & Tse (1999) also reviewed the interaction between entry mode and –timing' impact and found that 'WFOE's and EJV's that entered early have higher market shares than those who enter late' (1999:87). While the profitability of WFOE's and EJV's that entered early was not found to be more profitable than later entrants are.

3.9 Summary

Chapter 3 reviewed the market entry modes available to foreign investors in China. Each entry mode involves a number of advantages and disadvantages. Moreover each entry mode provides the foreign investor with different levels of levels of control over the operation on the one hand. On the other hand obtaining control over an operation requires resource commitment and risk. Figure 23 illustrates that a WFOE rewards the foreign investor with high control, while the risk and resource commitment is equally high.

Figure 23: Control vs Risk Trade-off between Market Entry Modes



Source: Compiled from Czinkot & Ronkainen (1998); Kotabe & Helsen (1998); Chee & Harris (1998) and Mead (1998)

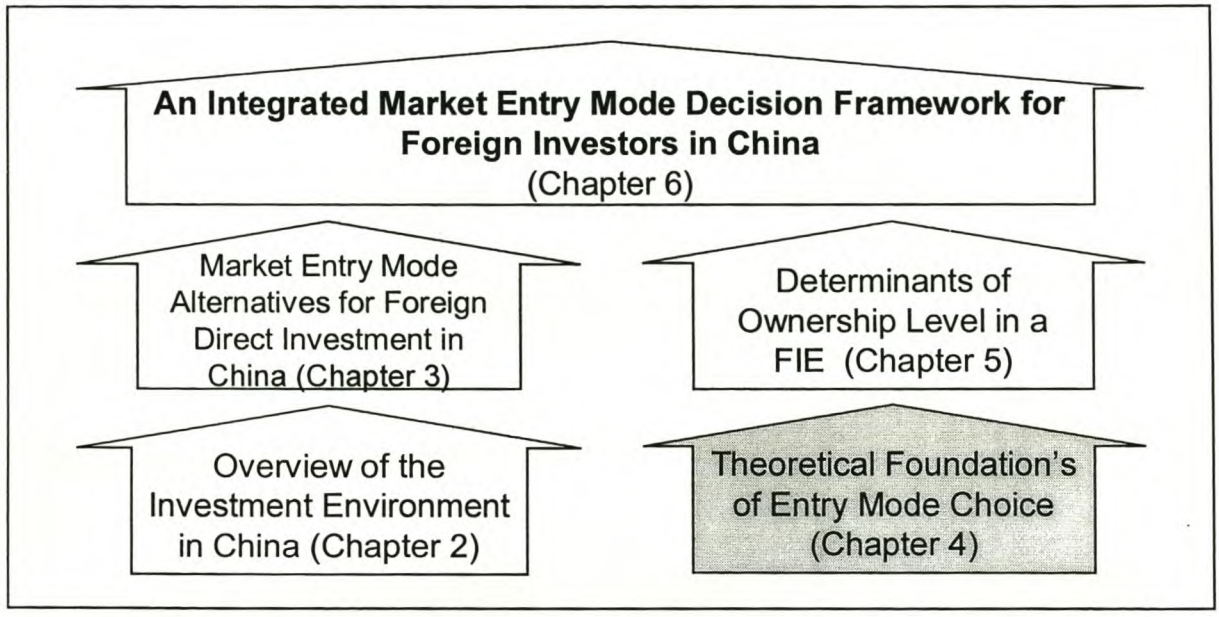
In view of Figure 23 the question of which entry mode to utilise while entering China can be reduced to what level of ownership, resource commitment or control should a foreign entrant adopt while entering China. The residue of the thesis will focus on the determinants of the level of resource commitment or ownership that a foreign entrant adopt.

4 Theoretical Foundations for Entry Mode Choice

4.1 Introduction

Chapter 2 and 3 provided the first pillar for entry mode choice in China. It established an overview of the investment environment, and in that context described the entry mode options available to the foreign investor in China (see Figure 24). However to review the entry mode decisions from an empirical research perspective, it is necessary to return to the theoretical foundations of entry mode choice as found in literature.

Figure 24: Market Entry Mode Decision Building Block Three



Most of the entry mode research is performed from a single or a few theoretical perspectives. Bell (1996: 13) identifies the following basic theories that should be used as a starting point and a conceptual framework for dealing with the entry mode question:

- Hymer's Market Imperfections Theory of FDI (Hymer: 1960, 1976)
- Transaction Cost Economies (Williamson: 1975, 1985)
- Internalisation Theory (Buckley and Cassson: 1976, 1996, 1998; Buckley: 1998; Buckley, Burton & Mirza: 1998)
- Dunning's Eclectic Paradigm (Dunning: 1981, 1988, 1993)
- Strategic Behaviour Approach (Kogut: 1988, Harrigan: 1985, Porter: 1991.)

- Resource-Based Theory (Penrose: 1959; Wernerfelt: 1984, 1995; Mahoney and Pandian: 1992)
- Eclectic Theory of the Foreign entry mode choice (Hill, Hwang, and Kim: 1990)

Although the Evolutionary (Kogut & Zander: 1993; Luo & O'Connor: 1998; Cui: 1997) and Institutional (Davis: 2000) theories of the firm can be included in the list, it will not be reviewed at this point. The majority of entry mode determinant research built on the listed theories and the chapter will aim to provide an understanding of the theories underlying extant entry mode research.

4.2 Hymer's Market Imperfections Theory of Foreign Direct Investment

Calvet (1981:43-51) abridges theories of foreign direct investment. He advances that Kindelberger was the first to submit a theory for foreign direct investment based on the neo-classical perfect competition model. In a world of perfect competition FDI cannot exist. In a perfect market no external economies exist. Information is obtained without cost and no barriers to trade or competition exist. Trade only is possible. Thus Hymer propound a market imperfection theory to FDI. In contrast to perfect markets, local firms possess better information about their economic environment. Two conditions exist for FDI to take place. First a firm must have an advantage above other firms, which will make the cost of an investment viable, and secondly the market for this advantage must be imperfect. The following classifications of the market imperfection theory exist:

Market Dis-equilibrium Hypotheses: The assumption can be made that in a perfect economy, subject to perfect competition, adjusted prices everywhere will bring in equilibrium supply and demand factors. However in segmented markets the rates of return may not be the same everywhere. Under such circumstances given the level of risk, the rates of return are not equal in every country. FDI will flow to higher ROR countries as the market is again in equilibrium. Upon equilibrium FDI will cease to exist. This hypothesis can also be applied to labour and technology markets.

Government Imposed Distortions: Among others, government policy may be responsible for the dis-equilibrium explained above. Direct distortions include fixed exchange rates, wage policies, regulations, tariff and trade barriers. However no equilibrating forces exist to correct distortions created by the government. In other words every government must have the same policies in order for FDI to cease to exist.

Market Structure Imperfections: Above illustrations are consistent with competitive market structure. On the other hand 'market structure imperfections are brought about by the existence of monopolistic and oligopolistic market characteristics' (1981: 46). Two characteristics of monopolistic or oligopolistic markets should be highlighted. Firstly, decisions of firms are maximised if such markets are interdependent. For example the few competitors closely monitor each other's moves and adjust their strategies and tactics accordingly. Secondly, barriers to market entry is a requirement to prevent a surge of competitors.

Market Failure Imperfections: 'Market failure imperfections are characteristics in production techniques and commodity properties, which prevent a market mechanism from allocating resources efficiently' (1981: 47). Three types of imperfections exist that lead to market failure: external effects, public goods, and economies of scales.

4.3 Transaction Cost Economies

Nooteboom (1996: 16 – 24) drawing on a number of authors syncopate the transaction cost economy. Two perspectives exist in the transaction cost analysis (TCA). Firstly a long-term objective that aims to identify the survival of the fittest governance forms. Or differently stated, to select a governance structure which will provide for long term success. Secondly, the transaction cost economy facilitates short-term managerial choices, which explains why managers in divergent situations select varying make-or-buy decisions.

Nooteboom defines a transaction as 'the moment at which agreement is established and ownership rights are transferred' (1996: 17). The transaction consists of three divergent phases: contact, contract and control. Each of the three stages represents costs of the transaction. The contact phase will incur cost for marketing services, searching a partner or researching. Costs of preparing and concluding the contract are costs during the contract phase, whereas costs of monitoring the implementation of the contract are to be calculated during the control phase.

The cost of contract and control increases principally when the buyer and supplier make specific investments, which are worthless outside the transaction. For example a mould that can only be used for the customer's product. In such instances the parties become dependent on one another and switching costs are too high to change partners. Drawing on

Williamson (1975), Nooteboom (1996) points to three types of specific investments: site specificity, physical assets specificity and human asset specificity. Transaction costs incurred due to specific investment will provide incentives to integrate activities into one firm.

Eramilli and Rao (1993) confirms the above argument by referring to Williamson (1985) asserting that a given task can either be performed internally or it can be contracted to external agents. Whether to perform the task internally or not will depend on the comparative transaction costs of running a system (including ex ante cost of negotiating a contract and ex post cost of monitoring the performance and enforcing the behaviour of the parties to the contract). When markets operate under perfect conditions it would not be necessary to monitor partners since they would be easily replaceable. But if the market fails these costs of monitoring will increase. Cost of monitoring must be compared by the cost of integration (of establishing an integrated operation).

The TCA predicts that firms integrate when assets specificity is high, because the higher cost of vertical integration is comfortably offset by the benefits flowing from such an arrangement. When specificity is low, firms refrain from integration because the benefits of control, falls short of the cost to attain it (Erramilli and Rao: 1993).

In short the TCA view the entry mode decision from a cost perspective. Whether to perform a given task by itself or with a partner will depend on which is the most cost effective. Nooteboom (1996) criticises the transaction cost theory in that it merely provides comparative static of governance structures, and does not allow for a dynamic view of the multi-national enterprise (MNE). It also omits a resource-based view of the firm.

4.4 Internalisation Theory

Buckley and Casson (1976) introduced and explained the theory of internalisation. Costs and benefits of internalising markets govern the growth of the multinational firm. Giving a background to the theory he explains that during the period up the Second World War the force behind MNE growth was the need to regulate raw materials internationally. After the Second World War MNE growth was driven by the need to diffuse technical and marketing know-how in a way that best maintained the intellectual property of the innovating firm.

Underlying the internalisation theory lie the assumptions of the orthodox theory of production: profit maximisation and perfect competition. Internalisation is still dependent on the

assumption of profit maximisation, but recognises and relaxes the perfect competition assumption to accommodate monopolistic and oligopolistic reaction. It also allows for general forms of market imperfections, which are derived from imperfect intermediate product markets.

4.4.1 Description of the Internalisation Theory

Buckley and Casson (1976: 33) advance by stating the main assumptions of the theory. First, firms maximise profits in a world of imperfect markets. Second, when markets in 'intermediate products are imperfect the incentive exists to bypass them by creating internal markets under common ownership and control activities'. Third, the internalisation of markets across borders creates MNC's. Internalisation will be undertaken to the point where the benefits are overtaken by the costs.

Intermediate products refer to any semi-processed material, which are used as input in the process. However it also includes knowledge and expertise as embedded in patents and human capital.

Rugman (1981: 27) asserts that the 'essence of the internalisation theory is the recognition of market imperfections, which prevent the efficient operation of international trade and investment'. Rugman further simplifies internalisation by stating 'internalisation is the process of making a market within the firm' (1981: 28).

Four main sets of factors come into play with internalisation as suggested by Buckley and Casson (1976: 34):

Industry Specific Factors: the nature of the products and the structure of the market.
Region Specific Factors: geographic and social characteristics of the region.
Nation Specific Factors: political and fiscal relations of the nation.
Firm Specific Factors: the ability of the management to organise internal markets.

4.4.2 Benefits of Internalisation

The benefits of internalisation are argued to rest in the avoidance of market imperfections. Five types of market imperfections were identified which leads to benefits for internalisation (Buckley and Casson 1976: 37):

Time Lags: inter-dependant activities in markets may lead to significant time lags between initiation and completion of activities.

Discriminatory Pricing: exploitation of market power may be done through discriminatory pricing which is only feasible through internalisation.

Unstable bargaining situation: a situation exists, where a party's bi-lateral power leads to uncertainty in pricing and unstable barging, the uncertain situation may provide an incentive for internalisation.

Buyer Uncertainty: in a situation where a difference in knowledge of the product between the buyer and seller exists and the seller is unable to convince the buyer that the product is sold at a reasonable value, the buyer might want to shoulder itself against the risk and internalise.

Government Interventions: the moment government impose restrictions, for example tariffs on imports or exports or other non-tariff barriers on trade, the MNE will have an incentive to internalise its production in the host country.

4.4.3 Costs of Internalisation

The benefits of internalisation should be offset against the cost of internalisation. A risk of internalisation may be that the firm does not operate at a level of economies of scale. This can however be corrected by using a system of selling excess production on the open market or alternatively to buy intermediate products where internalised production is not sufficient. The main cost items to be considered under internalisation are the resources cost due to fragmentation of markets, higher communication cost internally and the risk of political discrimination from the host country government. However the net benefit of internalisation will depend on the ability of management to co-ordinate internal markets. (Buckley and Casson: 1976)

4.5 Dunning's Eclectic Paradigm

Dunning (1981: 9-31) submits that the propensity of an enterprise to engage international business has three determinants. First, the extent it possesses (or acquires) assets which the competitors do not possess. Secondly, its desire to sell or lease these assets to other

firms vs. to make use of them internally and thirdly, how profitable is it to exploit these assets in conjunction with indigenous resources of foreign countries, rather than home country.

Dunning (1981) propounds the Ownership, Location & Internalisation (OLI) paradigm for international production (See Table 6). The more ownership specific advantages possessed by the firm, the greater the inducement to internalise, and the wider the attraction of foreign rather than home based manufacturing. However for a company to produce successfully alongside indigenous firms it must possess additional ownership advantages sufficient to outweigh the cost of servicing an unfamiliar or distant environment. The function of the enterprise is to transform inputs into more valuable outputs. Two kinds of inputs are identified: First those available on same terms to all firms, regardless size-, or nationality of the firm, but which are specific in their origin to particular location and have to be used in that location. Second, inputs that an enterprise may create for itself based on technology, organisational skills, or buy from other institutions. These inputs normally include proprietary right of use. Although the origin of the second type of inputs may be linked to location–specific endowments, their use is not so confined.

'The possession of ownership advantages determines which firms will supply a particular foreign market, whereas the pattern of location endowments (assets) explains whether the firm will supply that market by exports or by local production' (Dunning 1981: 10). The internalisation strand of the theory deals with the question why does a firm choose to use ownership advantages itself? Why does it internalise its capital, technology, and management skills to produce goods rather than externalise their use by engaging in portfolio investment, licensing, management contracts and so on? The theory offers that basic incentives to avoid disadvantages, or capitalise on the imperfections of one or the other of the external mechanisms of resources allocations – the market or prices system and the public authority fiat (Dunning: 1981). Table 7 provides insight into the determinants and indicators relevant in the OLI framework.

Table 6: OLI – Determinants of International Production

Types of International Production	Ownership Advantages	Location Advantages	Internalisation Advantages	Illustration of types of activity which favour MNE's
Resource-Based	Capital, Technology, Access to Markets	Possession of Resource	To ensure stability of supply at right price. Control of Markets	Oil, copper, tin, zing, bauxite, bananas, pineapples, cocoa, tea
Import Substituting Manufacturing	Capital, Technology, Management and Organisational skills, Surplus R&D capacity, Economies of Scale, Trade marks	Material & Labour Costs, Markets, Government police —barriers to imports and investment incentives	Wish to exploit technology advantages, High transaction or information costs, Buyer uncertainty, etc.	Computers, pharmaceuticals, motor vehicles, cigarettes
Export Platform Manufacturing	As above but also access to markets	Low labour costs. Incentives to local production by host governments.	The economies of vertical integration	Consumer electronics, textiles and clothing, cameras, etc.
Trade & Distribution	Products to distribute	Local Markets. Need to be near customers. After-sales servicing etc.	Need to ensure sales outlets & protect company's name	A variety of goods – particularly those requiring close consumer contact
Ancillary Services	Access to markets (in the case of other foreign investors)	Markets	As per 2 and 4	Insurance, banking & consulting services
Miscellaneous	Variety – but include geographical diversification (airlines & hotels	Markets		Various kinds a)Portfolio Investment b)Where spatial linkages essential (airlines & hotels)

Source: Dunning (1981:13)

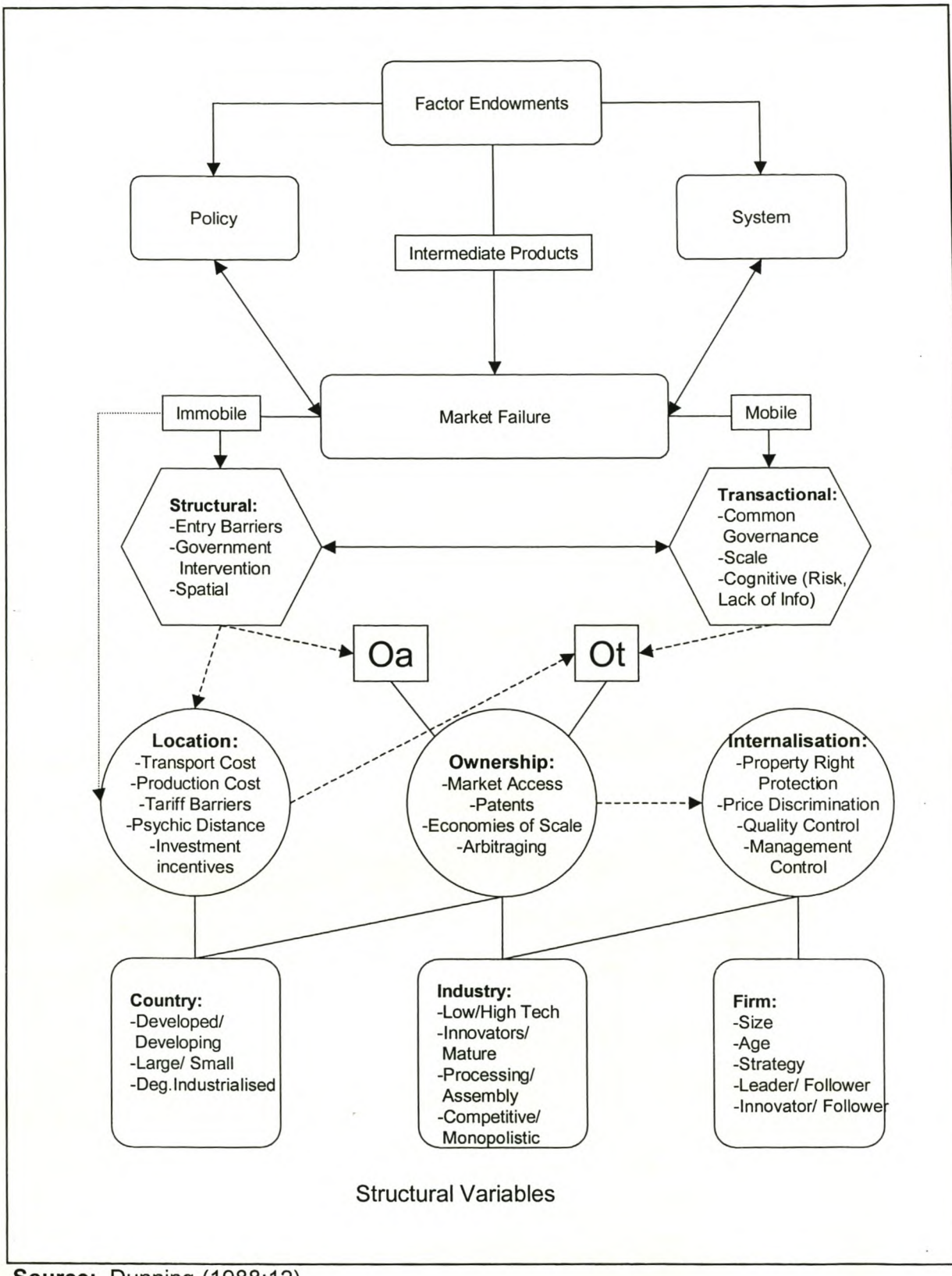
Dunning (1988) restates and extends the eclectic paradigm in Figure 25. Dunning is convinced that a holistic theory of production should be drawn from the 'new classical theory of factor endowments (assets), extended to embrace intermediate products, and to allow for the possibility that some endowments are mobile across national boundaries' (1988: 11). The more even distribution of factor endowments is among nations, the more likely international production is to take place. Dunning advances that the second strand is the theory of market failure, which also explains the division of activity between multi-national and local firms. 'Cetris paribus, the higher the transaction costs of using the market as a transactional model, and the greater the efficiency of MNE's as co-ordinators of geographically disperse activities, the more international production is likely to take place' (1988: 11). Thus Dunning distinguishes between 'Oa' – ownership assets and 'Ot' - ownership transaction advantages in his model.

Table 7: OLI – Ownership and Location Advantages

Ownership Advantages: Specific Determinants	Location Advantages: Specific Determinants
Access to Productive Knowledge: Skilled/Unskilled Ratio* R&D as % of Sales*	**Production Costs:** Wages per man hour Energy costs (eg. Electricity) Materials Costs Tax Rates* Average Number of Countries MNE operates in
Economies of Scale: Size of Firm* Relative size of Enterprise Non-Production/All Workers* Capital/Labour Ratio	**Transfer Costs:** Transport Costs Tariffs Non-Tariff Barriers
Opportunities for Investment Size of Local Market Size of Local Market + Exports	
Diversification Indices Average Number of Countries Operates in* % of foreign/total production of home firms Number of product group of parent* % of shipments from multi-plant enterprise to total shipments (in home country)*	**General:** Political Risks
Market Concentration: % output of industry accounted for by largest firms	
Efficiency: Wage Costs (per man hour) of production workers	
Resource Availability: % of main materials imported* % of main materials used in production process	
Product Differentiation: Advertising/ Sales Ratio	
Oligopolistic Behaviour: Entry Concentration Index	
Ownership Advantages: General Determinants	**Location Advantages: General Determinants**
Productivity: Net output or sales per man	**Productivity:** Production Cost per man Net output or sales per man
Profitability: Profits/assets	**Profitability:** Profits/Assets or Sales
Growth: Increase in sales	**Growth:** Increase in Sales

Source: Dunning (1981:17)

Figure 25: The Endowment/ Market Failure Paradigm of International Production



Source: Dunning (1988:12)

Itaki (1991) however criticises the eclectic paradigm. Firstly, Itaki suggests that the ownership advantage has become redundant in that it originates from internalisation and integration, while the cost of acquiring ownership advantages is neglected. 'After paying for the contribution of all the factor inputs, super normal profit that remain in the firm's results simply from the firm's organisational power of internalisation and integration' (1991:447). Secondly, ownership advantages are argued to be inseparable from location advantages. When looked at from an economic and not an engineering perspective, the ownership advantage is tied to, and is influenced by the location and should be considered simultaneously.

Dunning (1995) re-appraised the eclectic paradigm in an age of alliance capitalism. First, Dunning suggests that the concept of competitive advantages (of ownership) 'should be extended to take explicit account of the cost and benefits derived from inter-firm relationships and transactions (both at home and abroad) and particularly those that arise from strategic alliance and networks.' In considering location advantages, extended attention should be awarded to the following factors. 'The territorial embeddedness of interdependent immobile assets, in particular changing economic activities. Conditions under which inter-firm competitive enhancing alliances may flourish; and the role of national and regional authorities in influencing the extent and structure of localised centres of excellence'. Thirdly, the concept that firms internalise intermediate markets, primarily to reduce the transaction- and co-ordination cost of markets, needs to be widened to include dynamic and competitive enhancing goals of the firm (1995: 473).

4.6 Strategic Behaviour Approach

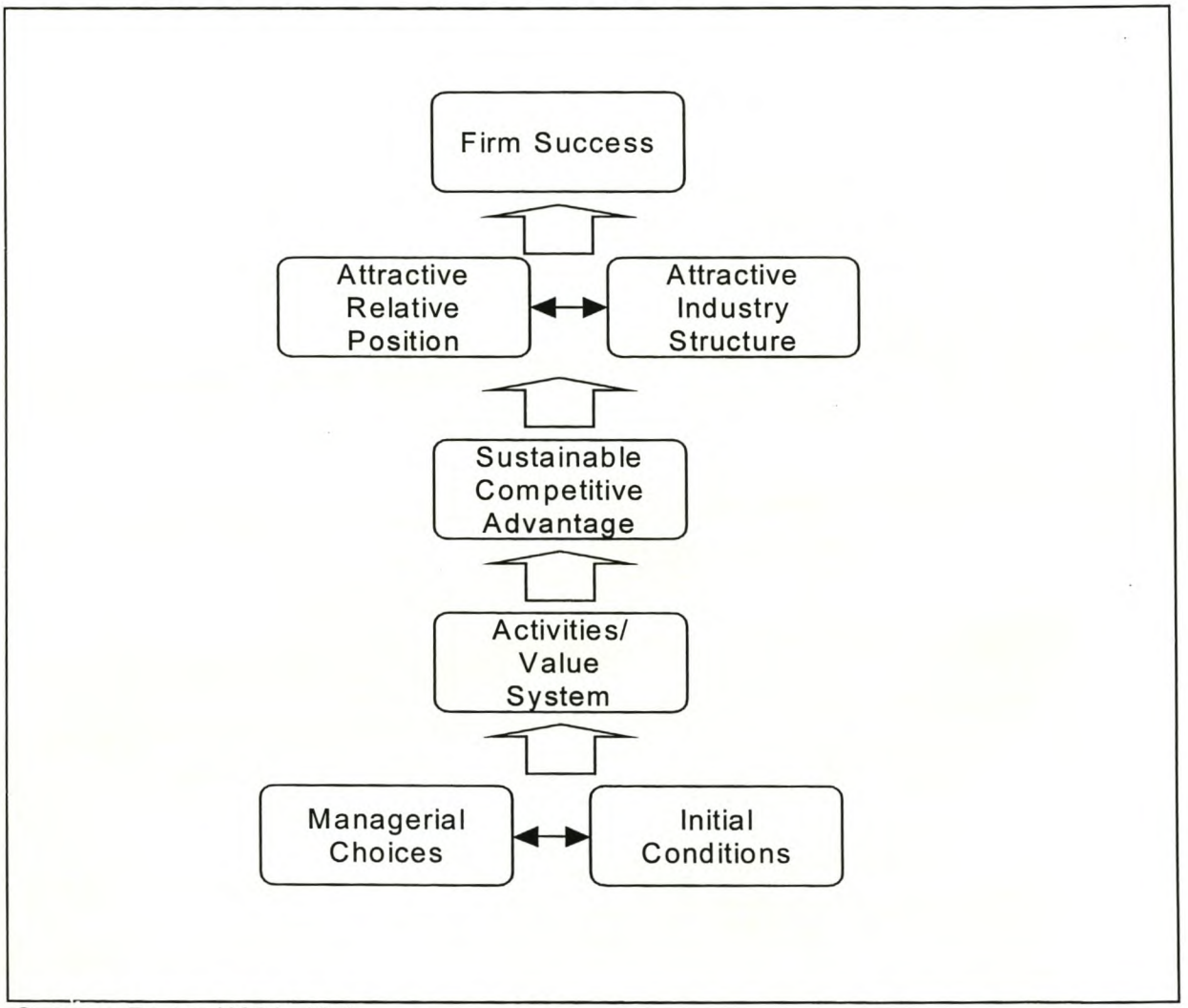
Kogut (1988: 322) submits, 'whereas transaction cost theory posits that firms transact by the mode which minimises the sum of the production and transaction costs, the strategic behaviour approach posits that firms transact by the mode which maximises profits through improving a firm's competitive position vis-à-vis rivals' (1988:322). Kogut advances how a firm's asset value is influenced through the strategic behaviour of competitive positioning. A firm may be motivated to enter in a JV to deter entry or erode competitor positions.

Hoskisson, Hit,et al. (1999) describes the development of the strategic management field in the past two decades as dramatic. Referring to the earlier works on strategy he suggests it focussed on the fit between strategy and structure. Porter (1985) however extended these views to competitive strategy and competitive advantage.

4.6.1 Porter's Dynamic Theory of Strategy

Porter (1991: 95-117) proposes a dynamic theory of strategy. The 'reason why firms succeed or fail' is the fundamental question of strategy (1991: 95). To explain why firms succeed or fail, a theory is needed to link the environmental circumstances and firm behaviour to market outcomes. Porter explores the question of success by suggesting a chain of causality in Figure 26.

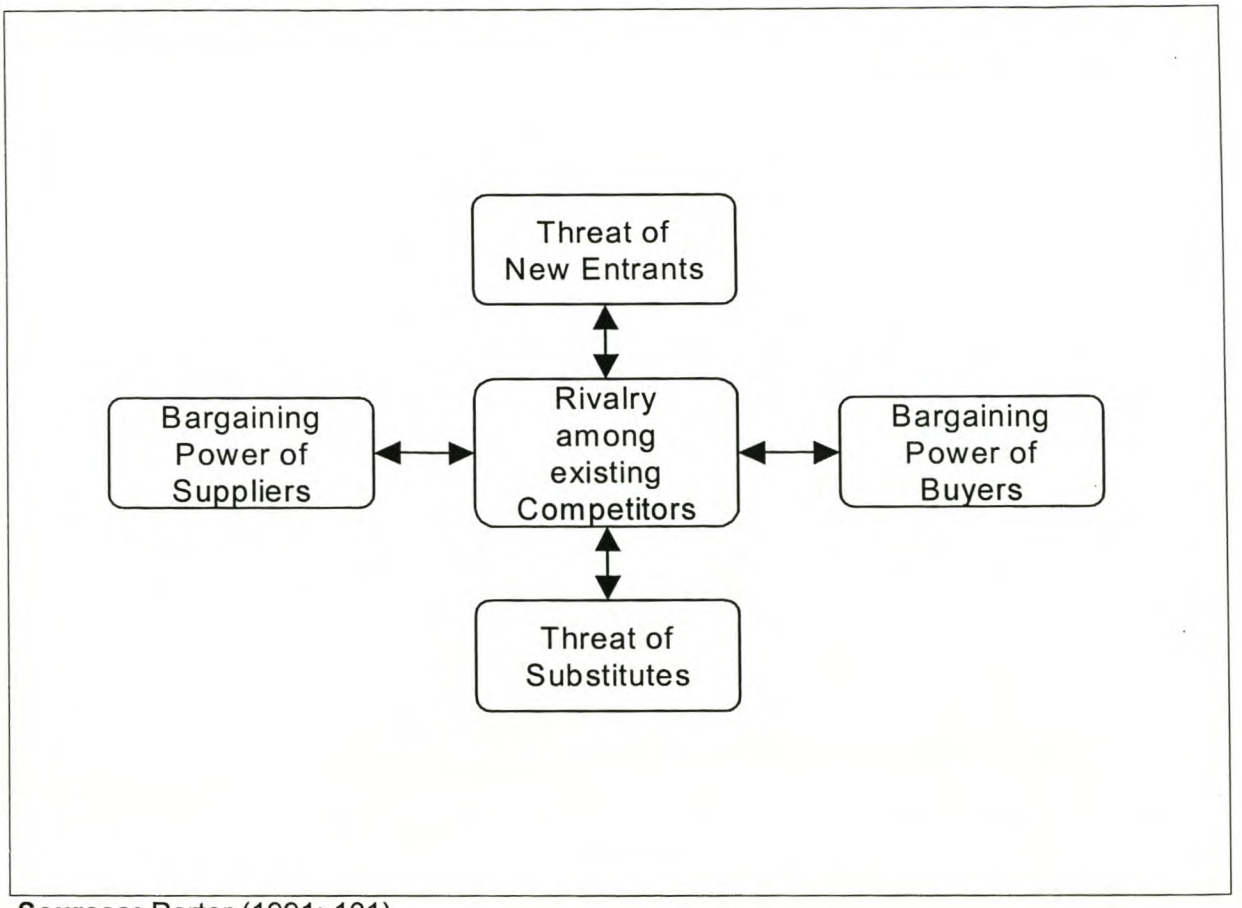
Figure 26: Porter's Determinants of Success in Business



Source: Porter (1991: 100)

A firm's success is a function of both the industry's attractiveness and the firm's relative position in that industry (industry effect and positioning effect). The industry's attractiveness or profitability will be dependent on the five competitive forces, as pictured in Figure 27. Since the five forces model is so well known, it will not be further explained.

Figure 27: Porter's Five Forces Model



Sources: Porter (1991: 101)

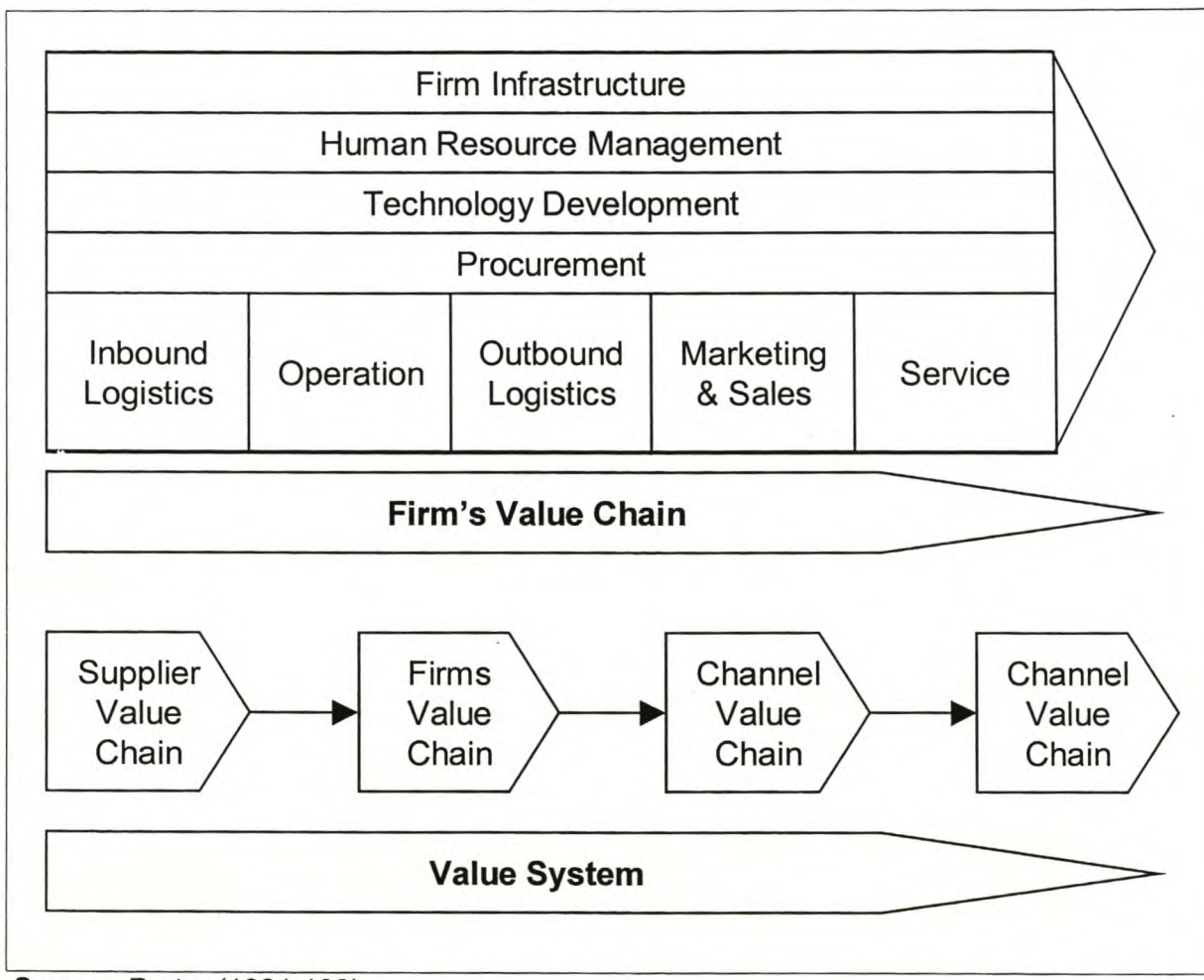
The question is however what determines the relative position in the industry. Porter advocates that a sustainable competitive advantage or advantages will result in a competitive position. The generic low cost- and differentiation strategies are suggested as basic strategies for developing a competitive advantage. Competitive advantage is also developed in the context of competitive scope, namely which products to offer, buyer segments to serve, locations to enter or what level of vertical integration to adopt. The choice of scope is central to strategy.

Still the question remains why some firms realise a cost or differentiation advantage. Underlying competitive advantage, are the activities (value chain) of a firm. A firm is a collection of activities as illustrated in Figure 28. Through the economics of performing a value chain, a firm can attain a cost advantage, or create more customer value.

Porter drives the why questions still deeper by identifying drivers or structural determinants of differences among competitors. Why are some firms able to produce at lower cost or

differentiate from others? A number of determinants are suggested, including: economies of scale, cumulative learning curves, linkages between value activities, the ability to share activities between divisions, capacity utilisation, activity location, investment timing, level of vertical integration, and institutional factors.

Figure 28: Porter's Value Chain and Value System



Source: Porter (1991:103)

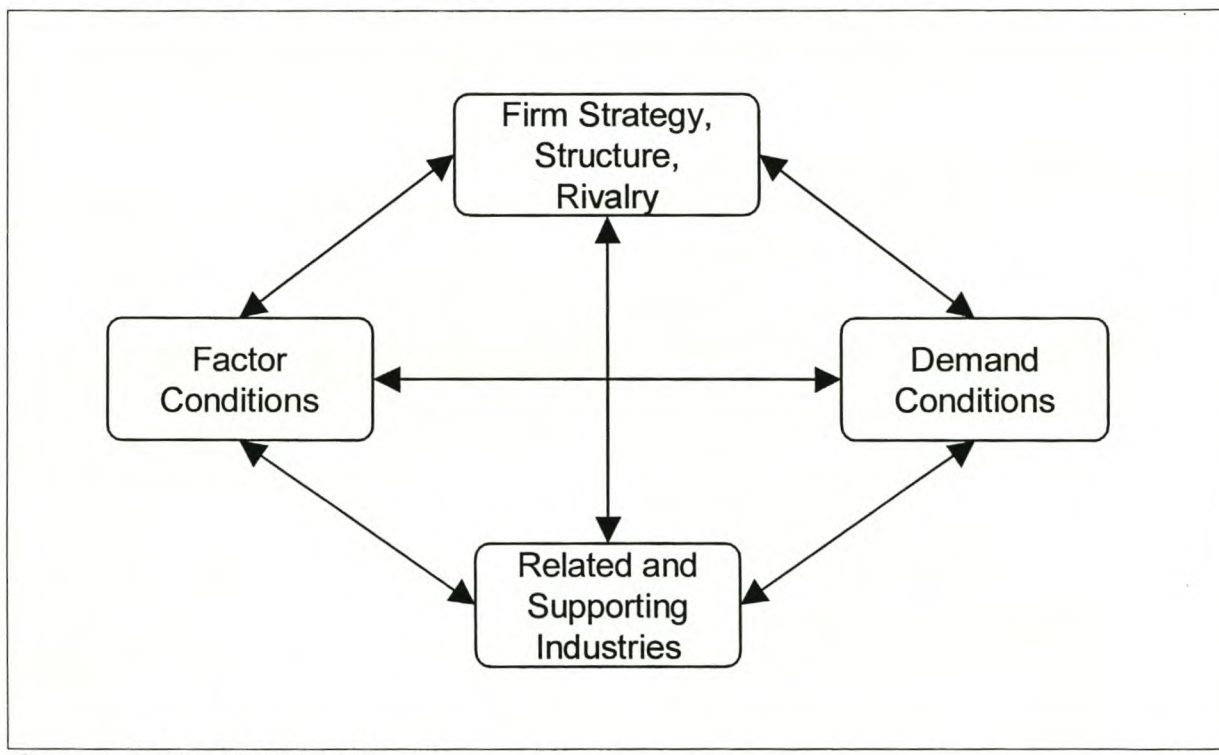
Porter identifies managerial choices and initial conditions at the root (see Figure 26). Numerous examples exist where companies succeeded entirely based on managerial innovations (e.g. Apple, Wal-Mart). Initial conditions, on the other hand, may include pre-existing skills, a reputation, or in-place activities. However initial conditions can be explained by a history of managerial choice.

From a firm perspective it can then be argued that a competitive advantage depends on a firm's ability to make good strategy choices and implement them. However, a dynamic theory needs to simultaneously deal with firm, industry and broader environment variables.

A competitive advantage originates both from within and outside the firm. The 'starting point for the theory is that environmental change is relentless and firms, through innovations, have considerable latitude in both influencing their environment and responding to it. Firms create and sustain competitive advantage because of the capacity to continuously improve, innovate, and upgrade their competitive advantages over time. Upgrading is the process of shifting advantages through out the value chain to more sophisticated types, and employing higher levels of skill and technology. Successful firms are those that improve and innovate in ways that are valued not only at home but also elsewhere. Competitive success is enhanced by moving early in each product or process generation, provided that movement is along a path that reflects evolving technology and buyer needs, and that early movers subsequently upgrade their position rather than rest on them. In this view, firms have considerable discretion in relaxing external and internal constraints' (1991: 111).

In Figure 29 Porter suggests that factor, demand and supporting industry conditions, needs to be considered as part of a dynamic process of strategy formulations.

Figure 29: Environmental Determinants of Innovation and Upgrading



Source: Porter (1991: 111)

In summary, relating the strategic behaviour approach back to entry mode choice, a foreign entrant will need to consider which entry mode is the most appropriate to implement its strategy and to best facilitate the development and protection of an competitive advantage.

4.7 The Resource-Based Theory

Hoskisson & Hit et al. (1999) argue that the resource-based view of the firm only became a dominant framework in the 1980's and 1990's, despite having its roots in the 1950's. A number of researchers have applied the resource-based view of the firm to the areas of strategic management and international business recently (Wernerfelt: 1984/1995; Peteraf: 1993; Sharma: 1995; Fay: 1996; Tsang: 1997; Jones: 2000; Das, T.K. 2000).

4.7.1 Penrose's Theory of the Growth of Firms

Kor & Mahoney (2000: 109) advocate the importance of Edith Tilton Penrose's (1959) classic: Theory of the Growth of Firms. Penrose's resource approach to the growth of the firm laid the foundation for the resource-based view of the firm. Kor & Mahoney (2000: 114-119) abstract Penrose's work into ten ideas as is illustrated by Figure 30 and Table 8.

Table 8: Penrose's Ten Idea's of the Resource Growth Process

- Idea 1: Firm growth can be usefully studied as a dynamic process of management interacting with resources.
- Idea 2: Firms are institutions created by people to serve the purposes of people.
- Idea 3: Services of resources are drivers of firm heterogeneity
- Idea 4: Service that material resources will yield depends upon the knowledge possessed by human resources. The two together create a subjective productive opportunity that is unique for each firm.
- Idea 5: Firm growth is a function of firm-specific experiences in teams.
- Idea 6: Managerial capability is the binding constraint that limits the growth rate of the firm – the so-called 'Penrose effect'
- Idea 7: Excess capacity of productive services of resources is drivers of firm growth.
- Idea 8:Unused productive service of resources can be a source of innovation.
- Idea 9: Firm diversification is often based on firm's competencies that can lead to a sustainable advantage.
- Idea 10: An important component of competitive process is experimentation.

Source: Compiled from Kor & Mahoney (2000: 114-119)

Central to Penrose 's theory is the concept that firms develop resources, which must be the basis for diversification strategies and creating a sustainable advantage.

4.7.2 Wernerfelt 's Resource-Based View of the Firm

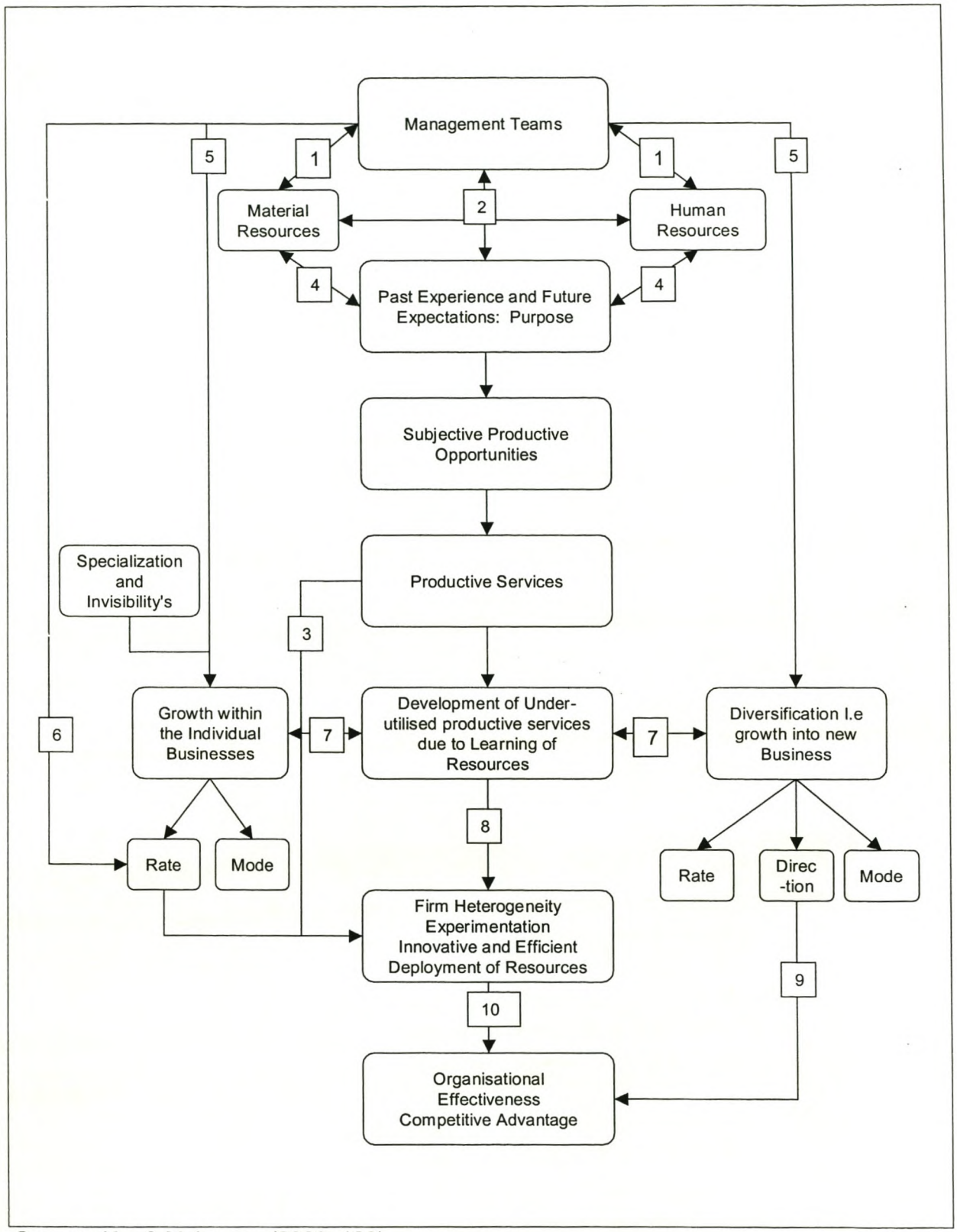
Wernerfelt (1984) add to Penrose (1959) by seeing a firm as an extensive set of resources. He suggests that firms should be viewed from the resource side rather than from product side, and introduces the concepts of resource position barriers. The resource-based view addresses key issues for strategy formulation, namely: On which resource to build a diversification strategy, which resources to develop through diversification, in what sequence and to what market to diversify, and finally what types of firms to acquire.

Wernerfelt utilises Caves' (1980) definition of a resource as tangible and intangible assets, tied semi-permanently to the firms. Such assets may include brand names, in-house knowledge of technology, employment of skilled personnel and trade contacts. Resources yield different returns under different circumstances. Drawing on Porter's five forces model (1991) it is suggested that when resources are controlled by a monopolistic group, or sold on monopolistic market or substitute resources are available, the yields on the resource will dissipate.

Higher yield can be realised where a firm holds a first mover advantage. The reality of the first mover firms holding the valued resources (e.g., valuable government contacts), affects the cost and revenues of later entrants. A resource position barrier protects such a first mover. A resource position barrier can be compared to an entry barrier, although an entry barrier only deals with barriers to the new entrants. Resource position barriers implies advantages over both new entrants and incumbents. Firms should strive to develop both, entry barriers and resource position barriers.

Classes of resources are effective in identifying the specific resource position barriers to be built up. Examples of resources in which resource position barriers can be build up, include machine capacity, customer loyalty, production experience and technological leads. Holders of resource barriers should strive for a position where resources become self-reproducing and making it directly or indirectly more difficult for later entrants to catch up.

Figure 30: Penrose's Model of the Resource Growth Process



Source: Kor & Mahoney (2000: 120)

Merger and acquisitions are viewed as an opportunity to buy otherwise non-tradable bundles of resources. Two resource-based criteria are suggested for evaluating an acquisition target: Whether resources are related supplementary (more of existing resources) or related complementary (if acquiring resources combine effectively with existing resources).

Wernerfelt promotes the use of a resource-product matrix to evaluate diversification strategy (See Table 9). Although the most common diversification strategy for companies is to utilise a single resource and enter all markets with that resource, it is suggested that resources should be developed sequentially. By employing a current resource in the local market, (e.g. domestic contacts) a further resource (e.g. production skills) can be developed (still in the home market). Upon being developed, the production skills can be leveraged to enter the international market, giving rise to another resource to be developed (e.g. international contacts)

Table 9: Resource-Product Matrix

	Resources			
Market	**Production Skills**	**International Contacts**	**Project Management**	**Domestic Contacts**
Domestic	X◄			X
International	X	► X		
Turnkey		X	► X	

Source: Wernerfelt (1984: 179)

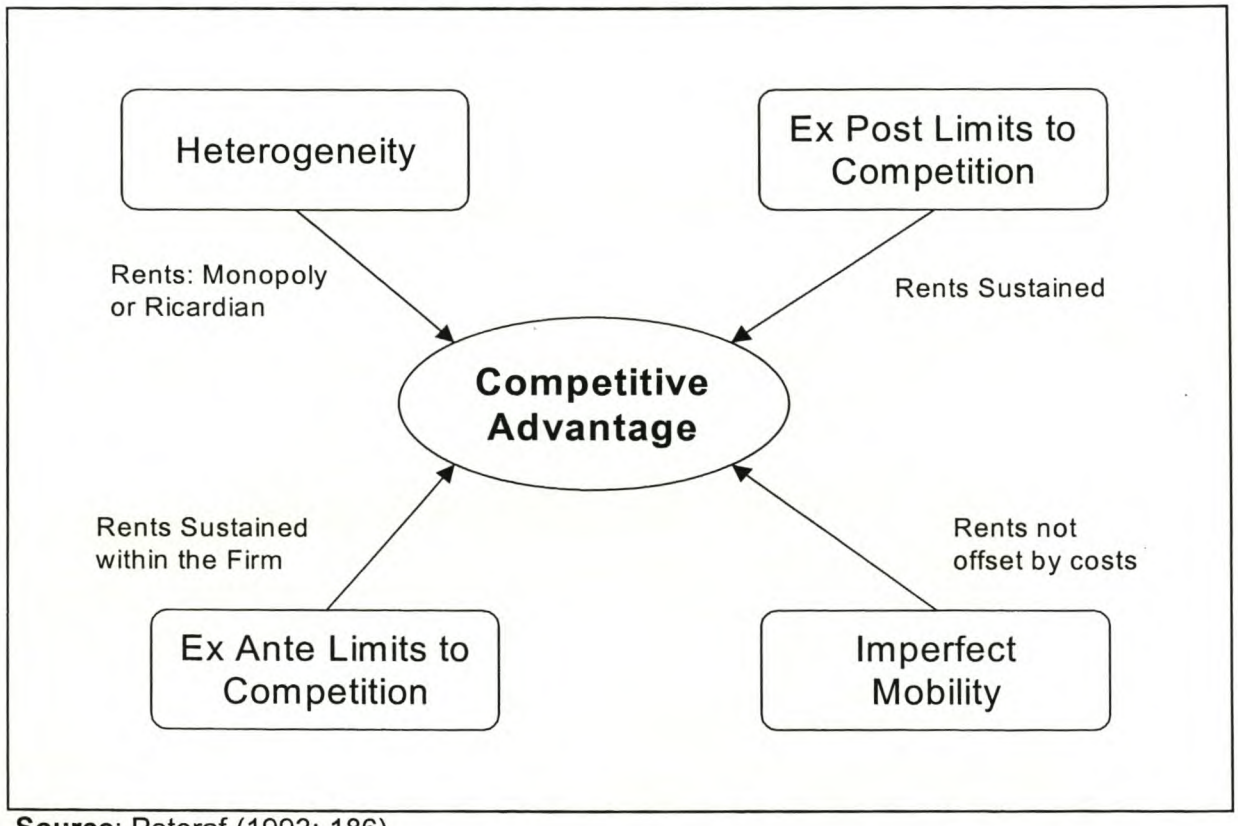
An important component of the resource-based view is to balance the exploitation and development of resources. Diversified firms can be viewed in terms of a portfolio of resources rather than products, in which a balance should be optioned between developing and exploiting resources. A final caveat from Wernerfelt is seeing the development of resources as stepping-stones. The Japanese first developed capabilities in chip manufacturing before it entering the computer industry as a natural next step (Wernerfelt: 1995: 171-180).

4.7.3 Cornerstones of Competitive Advantage – A Resource-Based View

Peteraf (1993) extends the concept of competitive advantage by supplying the cornerstones of a sustainable competitive advantage (see Figure 31). For a competitive advantage to be sustainable and to earn above normal rent, the following requirements need to be met:

The first requirement is resource heterogeneity from which Ricardian or monopoly rents can be earned. Resources differ in efficiency and superior resources will be able to gain higher rents. Secondly, ex post limits to competition, prevent advantages from being competed away. Being limits imposed on competition before they gain a dominant position. Imperfect imitatability and imperfect substitutability is suggested as such limits. Isolating mechanism (e.g. property rights) are suggested as an ex post limit. Thirdly, imperfect factor mobility ensures that valuable resources remain in the firm. Factors are imperfect mobile if the item cannot be traded. Such assets will be firm specific or co-specialised. Fourthly, ex ante limits to competition prevent cost from offsetting the rents. For example, if new entrants compete for a valuable location, the cost of the location will increase, leading to a reduction in rents to be earned.

Figure 31: The Corner Stones of Competitive Advantage



Source: Peteraf (1993: 186)

4.7.4 A Resource-based View of Strategic Alliances

Das (2000) applies the resource-based view to create a resource-based theory of strategic alliance. He views strategic alliances and merger/acquisition, as a means of gaining strategic access to valuable resources (e.g. market contacts and -knowledge). The

resource-based view also specifies the conditions under which firms will favour alliance over M&A's. Obtaining resources and retaining resources are the two motivations for alliances (Kogut (1988). Firms might wish to access international markets by M&A or alliances to access resources.

4.7.4.1 Types of Resources

Das (2000: 31-61) distinguishes resources based on it characteristics (imperfect mobility, imperfect imitatability and imperfect substitutability) and whether it is a property based resource or a knowledge-based resource. See Table 10 for examples.

Table 10: Typical Resources Based on Resource Characteristics and Resource Types

Resource – Characteristics	Property-Based Resources	Knowledge-Based Resources
Imperfect Mobility	Human Resources	Organisational Resources (Culture)
Imperfect Imitatability	Patents, Contracts, Copyrights, Trademarks and Registered Designs	Technological and Managerial Resources
Imperfect Substitutability	Physical Resources	Technological and Managerial Resources

Source: Das (2000: 31-61)

Consequently, Das (2000) proposes that the more a firm's resources are characterised by imperfect mobility, imperfect imitatability and imperfect substitutability, the more likely the firm will become involved in strategic alliances.

4.7.4.2 Impact of Resource Type on Ownership Structure

Table 11 identifies the structural preference under specific circumstances. A unilateral contract based alliance will be preferred when both partners' resources are mainly property-based. Examples of unilateral alliances include licensing, subcontracting and distribution agreements. It involves chiefly the exchange of capital, plants, and distribution channels.

Table 11: Resource Types and Firms Structural Preferences

	Partner Firm B: Property-Based Resources	**Partner Firm B:** Knowledge-Based Resources
Partner Firm A: Property-Based Resources	Unilateral Contract Based Alliance	Equity Joint Venture
Partner Firm A: Knowledge-Based Resources	Minority Equity Alliance	Bilateral Contract-Based Alliances

Source: Das (2000: 31-61)

Partner firm A who owns primarily property based resources will prefer a unilateral contract based alliance with partner a property based firm B, while it will prefer a EJV with a knowledge based firm B. Partner firm A, who primarily owns knowledge-based resources, will seek a minority EJV with a property based partner A, while a bilateral contract based alliance will be adopted with a knowledge-based partner B.

In conclusion, the resource-based perspective requires foreign entrants to ask the question how will the selected entry mode impact the exploitation of existing firm resources. Which entry mode will be best suited to develop and protect of firm resources?

4.8 Eclectic Theory of the Choice of International Entry Mode

Hill et al. (1990: 117-128) submits the eclectic theory of international entry mode. Although Anderson and Gatignon's (1986) framework for the entry mode choice holds promise, it is criticised as being too one sided in that it only takes a transaction cost perspective to entry mode choice. Hill et al. (1990) suggests that a united framework should incorporate strategic-, environmental- and transaction variables.

4.8.1 Foundations for an Eclectic Framework of Choice

Entry mode options can be reduced to licensing, joint ventures and wholly owned subsidiaries. Each mode has different implications for the degree of control, level of resource commitment, and the risk of dissemination proprietary know-how (as discussed in chapter 3).

With level of control is meant the level of authority over strategic and operational decision-making. Resource commitment implies dedicated assets that cannot be re-deployed without cost (loss of value). As resource commitment increases, the sunk cost (irrational exit barriers) to exit the market increases. Dissemination risk refers to the risk of dissemination of firm specific knowledge that will be appropriated by the licensing or joint venture partner

Table 12 highlights the impact of each entry mode on the level of control, resource commitment and dissemination risk. Licensing provides a low level of control over the operation, a low requirement of resources, but a high risk of dissemination of proprietary know-how.

Table 12: Characteristics of Different Entry Modes.

Entry Mode	Level of Control	Resource Commitment	Dissemination Risk
Licensing	Low	Low	High
Joint Venturing	Medium	Medium	Medium
Wholly Owned Subsidiary	High	High	Low

Source: Hill et al. (1990: 123)

4.8.2 Hill et al.'s Entry Mode Decision Framework

Hill et al. (1990) maintains that three groups of variables are relevant to this theory. Each of the groups of variables is connected to one or more of the following: level of control, resource commitment or dissemination risk. Strategic variables influence the entry choice through control requirement it entails. Environmental variables influence entry modes through their impact on resource commitment. And transaction cost variables influence both the dissemination risk and the level of control requirements.

The eclectic framework of the international entry mode decision is depicted in Figure 32. The following propositions are made (1990: 120- 125):

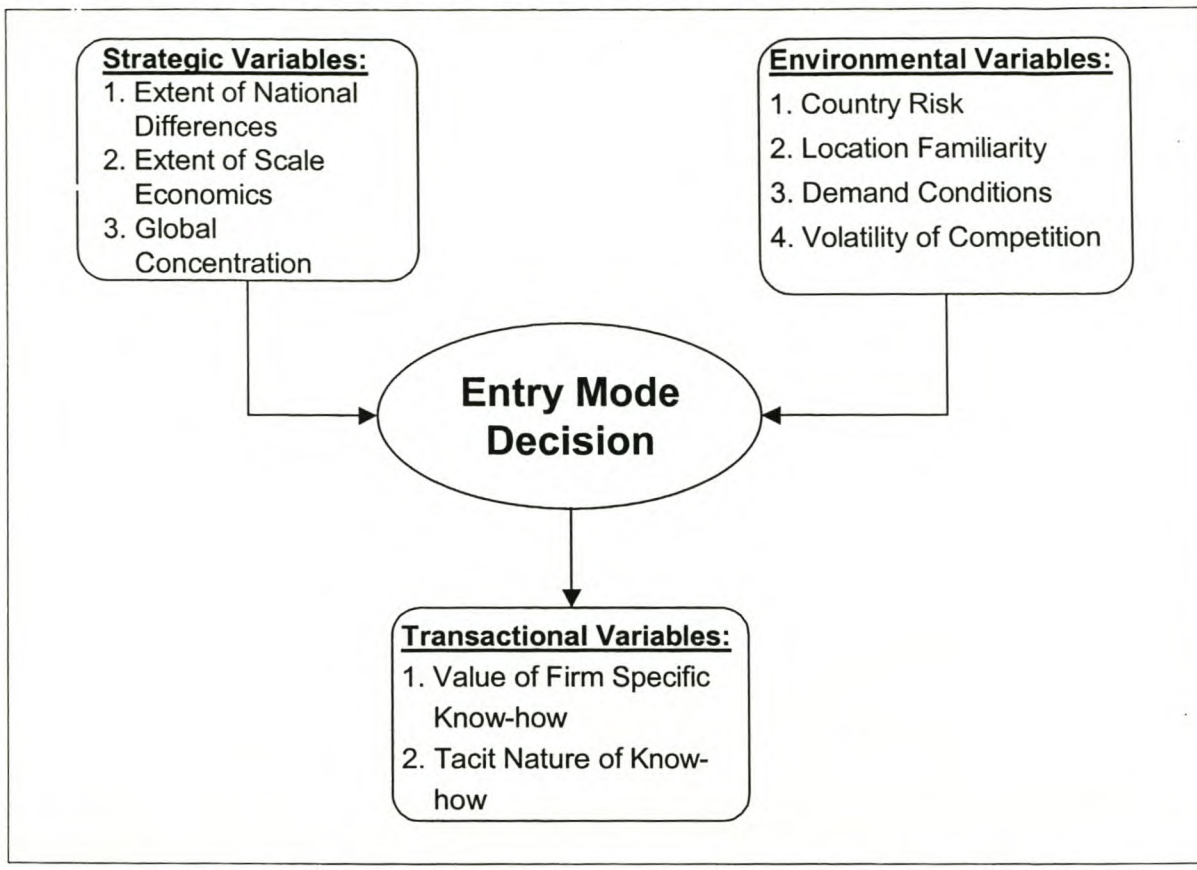
4.8.2.1 Strategic Variables

Firms have to choose between a global or multi-domestic strategy, as was expounded in 4.6. It is proposed that firms that pursue a multi-domestic strategy will favour low-control entry modes, while firms pursuing a global strategy prefer high control entry modes. Firms that have a strong need for global strategic co-ordination, (for example in global and oligopolistic industries) will favour high-control entry modes.

4.8.2.2 Environmental Variables

When the perceived distance in location familiarity is great, MNC's will favour entry modes that involve relatively low resource commitments. If demand conditions are uncertain, (as in embryonic or declining host markets) MNC's will favour entry modes that involve low resource commitments. The greater the volatility of competitive conditions in the host market, the more MNC's will favour entry modes that require low resource commitments.

Figure 32: Eclectic Framework of the International Entry Mode Decision



Source: Hill et al. (1990:120)

4.8.2.3 Transaction Cost Variables.

The greater the quasi-rent stream generated by a MNC's proprietary know-how, the greater the probability that the MNC will favour an entry mode that minimises dissemination risk. And the greater the tacit component of firm-specific know-how, the more an MNC will favour high control entry modes

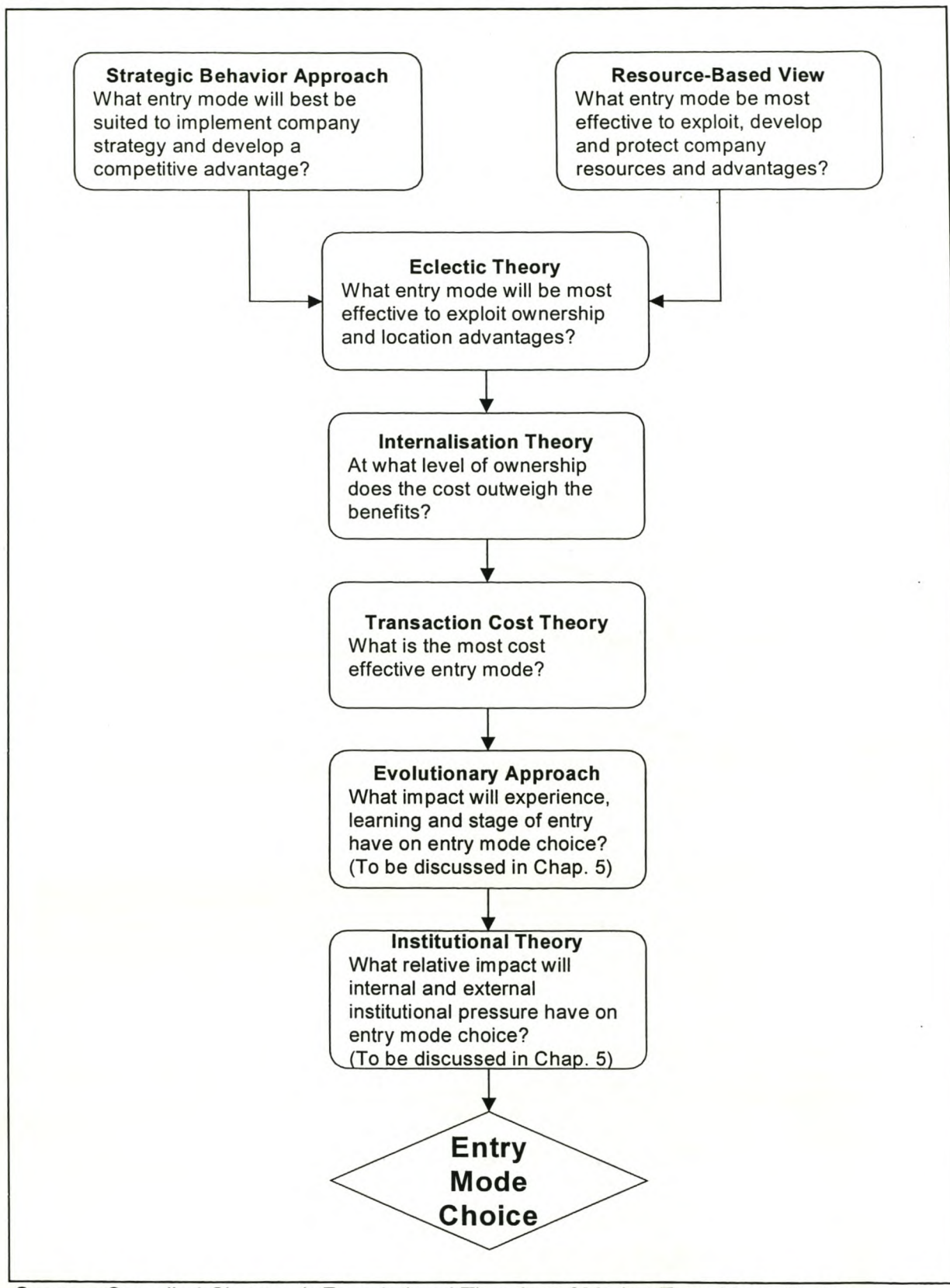
Hill et al. (1990) tenders that in practise the various groups of variables will indicate different directions for the entry mode choice. A possible solution might be to determine weights for each of the groups of variables. However companies with a high component of proprietary knowledge will consider the protection against dissemination of their knowledge to be of utmost importance. They maintain that the overall value of the corporation will weigh more than the individual subsidiary. High control will generally be preferred in homogeneous- and scale economics industries. Oligopolistic industries will place a high premium on the level of control.

4.9 Summary

Choosing an appropriate entry mode when entering into a foreign market proves to be a complex decision. The starting point is to grasp the theoretical foundations from which to consider the entry mode choice. Figure 33 depicts a logical sequence for considering an entry decision based on the reviewed theories.

Strategic- and resource-based view's suggest a firm should evaluate which entry mode will enable the entrant to effectively implement its strategies, develop a competitive advantage, exploit existing resources and protect intellectual property. Dunning's eclectic theory requires a firm to consider which entry mode is most appropriate given the firm's ownership and locations advantages. The transaction cost analysis cautions the entrant to consider the costs involved to adopt various governing structures, while internalisation seek to answer the profit maximisation question.

Figure 33: Summary of Foundational Theories' Impact on Entry Mode Choice



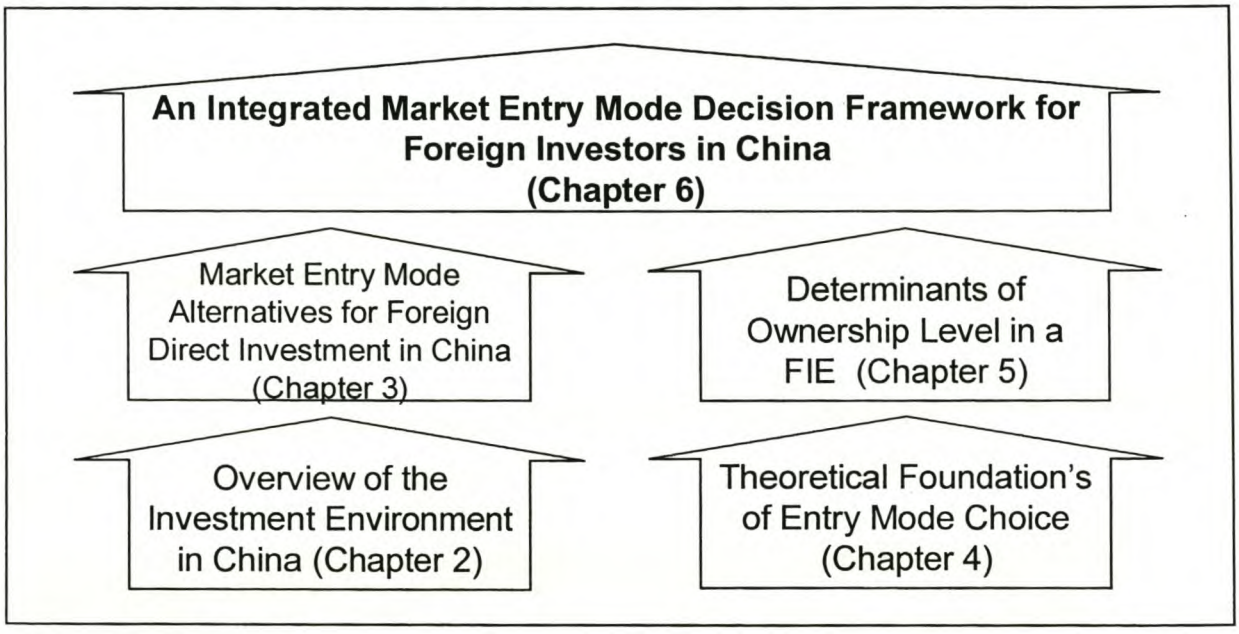
Source: Compiled Chapter 4: Foundational Theories of Market Entry Mode Choice

5 Determinants of Ownership Level in a Foreign Invested Enterprise

5.1 Introduction

The fourth building block to advance a market entry mode decision framework for foreign investors in China (MEMDFFIC) is to determine what the determinants of ownership level in a foreign invested enterprise are. As depicted in Figure 34, the review of entry mode determinants will build on its theoretical foundations as described in chapter 4.

Figure 34: Market Entry Mode Decision Building Block Four



Not only will it be required to identify relevant entry mode determinants, but rather to assess the impact that each determinant has on the ownership level in a foreign invested enterprise.

5.2 Existing Models of Entry Mode Choice

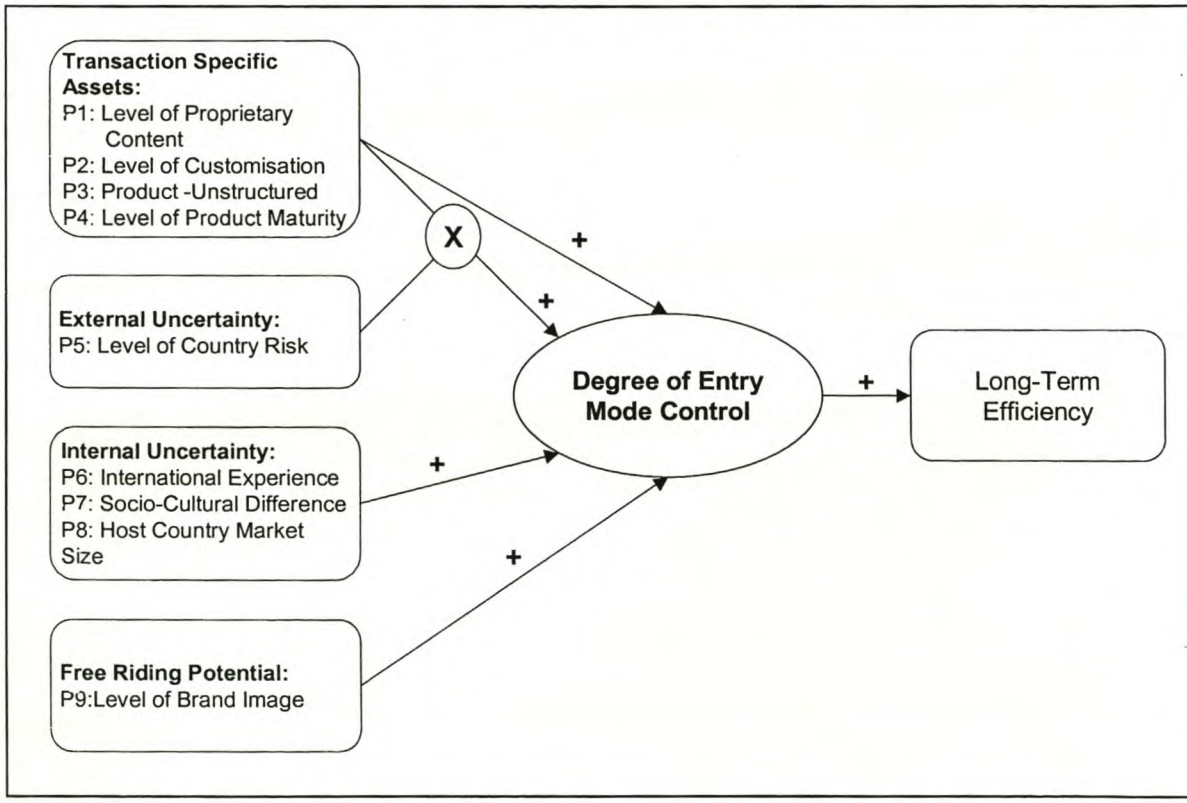
Owing to the limited scope of the thesis, it is not necessary to carry out a detailed review of the entry mode research. However, a few selected studies provide an overview of the status of the entry mode determinant research. The transaction cost framework of Anderson & Gatignon (1986), the eclectic framework of Bell (1996), and the resource-based view of Tsang (1997) are the most important to mention. In this section only the conceptual

framework of the model will be deliberated while the determinants identified in the frameworks will be discussed in the subsequent sections.

5.2.1 Anderson & Gatignon's Transaction Cost Framework for Analysing Efficiency of Entry Modes

Anderson & Gatignon (1986: 1-23) submit a transaction cost analysis of entry mode choice. Four determinants of entry mode from a transaction cost perspective are offered in Figure 35. To analyse the most efficient entry mode, a foreign entrant must first consider its level of transaction specific assets. Secondly, the external and internal uncertainty of an environment needs to be assessed while lastly, the potential for free riding (intellectual property abuses) must be appraised. Upon considering all these factors, an entrant will be able to decide on the degree of entry mode control that will yield long term efficiency.

Figure 35: A Transaction Cost Framework for Analysing Efficiency of Entry Modes

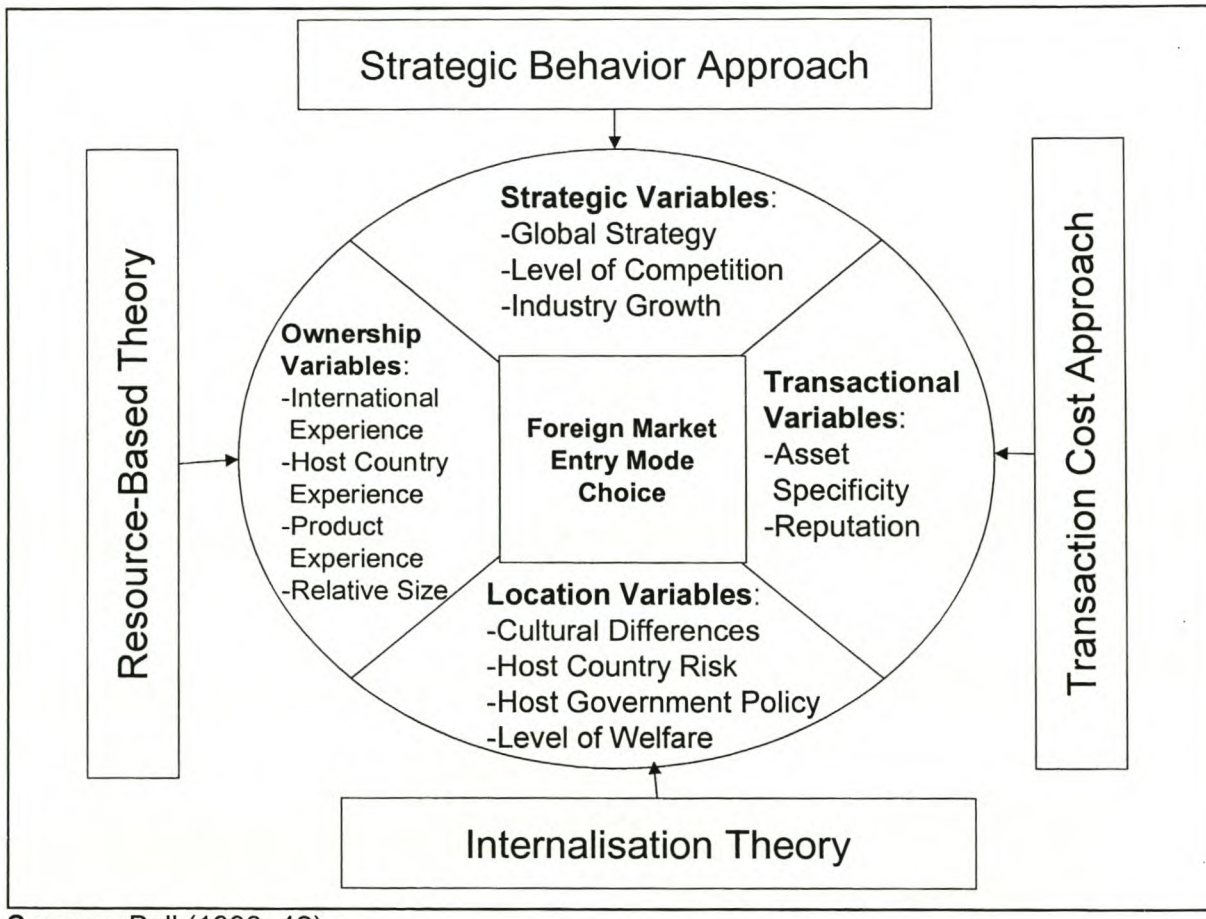


Source: Anderson & Gatignon (1986: 1-23)

5.2.2 Bell's Comprehensive Eclectic Framework for Entry Mode Choice

Bell (1996) offers a comprehensive review of the entry mode literature and proposes a framework for entry mode choice by integrating strategic behaviour-, resource-based-, internalisation- and transaction cost theories (see Figure 36).

Figure 36: Comprehensive Eclectic Framework for Entry mode Choice



Source: Bell (1996: 42)

Bell (1996) tests the results from a mail survey of Dutch firms by means of a confirmatory factor analysis, a binomial logit analysis, a multinomial logit analysis and an ordered logit analysis). The tables (see Table 13 and Table 14) highlights determinants as hypothesised, and offers a review of previous studies related to the impact of entry mode determinants on ownership level in a FIE. The results and findings of the study will be discussed in the subsequent sections where required.

Table 13: Impact of Strategic-, Transactional-, Location- and Ownership Variables on Ownership Level in a FIE

Variable's	Impact on Ownership		Comments
Strategic Variables:	**Hypothesis**	**Confirmed?**	
Global Strategy	+	Ns	+ but not significant
Level of Competition	-	+	
Industry Growth	-	-	
Transactional Variables:	**Hypothesis**	**Confirmed?**	
Asset Specificity	+	+	
Reputation	+	+	
Location Variables:	**Hypothesis**	**Confirmed?**	
Cultural difference	?	+/-	JV when either small or large
Host Country risk	-	-	
Host government Policy	-	Ns	
Level of welfare	-	-	
Ownership-Specific:	**Hypothesis**	**Confirmed?**	
International Experience,		+	
Host Country Experience;	+	+/-	
Mode Experience - JV;	-		Not Tested
Mode Experience – WFOE;	+		Not Tested
Product Experience;	+	Ns	
Relative Size of Subsidiary	+	+	

Source: Compiled from Bell (1996)

5.2.3 Tsang's Resource-Based View of Entry Mode Choice

Tsang (1997: 151-168) submits a resource-based view to construct a model for explaining a firm's selection of international technology transfer mode. 'Technology transfer is the transmission of knowledge which enables the recipient firm to manufacture a certain product or provide a particular service' (1997: 155). Figure 37 explains the elements of the model. In dealing with an international technology transfer, a firm needs to review its resource constraints, consider the resource requirements of the host country or transferee, and determine how to protect its valuable resources while transferring it. These factors will limit the range of transfer modes but the firm's strategy will determine which transfer mode to utilise. Owing to strategic considerations, firms may opt for higher control options to gain for example first mover advantages or experience, even when it is not profitable. However, smaller firms will not have the capability to utilise strategies that will drain its resources over the long haul. Tsang does not offer any proposition regarding strategy, but suggest that 'strategy is a more important moderating factor for smaller firms than larger firms' (1997: 162). In addition, a firm needs to consider how to develop its resources as part of the transfer strategy.

Table 14: Determinants of Ownership Level and Resource Commitment of Foreign Market Entry

Variables (+ Increase/ - Decrease or Not Significant)	Gatignon and Anderson (1988)	Kogut and Singh (1988b)	Gomes-Casseres (1989)	Gomes-Casseres (1990)	Erramilli (1991)	Erramilli (1991)	Hennart (1991)	Agarwal and Ramaswami (1992a)	Agarwal and Ramaswami (1992b)	Larimo (1993)	Erramilli and Rao (1993)	Brothers et al. (1993)	Shane (1993)	Argwal (1994)	Madhok (1994)	Padmanabhan (1994)	Bell (1996)
Strategic Variables																	
Global Strategy																	Ns
Level of Competition		Ns															+
Industry Growth		Ns				-											-
Location Variables																	
Cultural Distance	-				-				-	Ns	-			-	+	+	+ -
Host Country Risk	-							Ns	+			+	-				-
Host Government Restriction	-		-	-									-			-	Ns
Level of Welfare host Country			-	-						+			-	-			-
Ownership Variables																	
Size – Firm				+				+			-					Ns	
Size – Subsidiary	Ns				-											Ns	
Size - Relative of Investment		-					Ns			Ns							+
Experience - International	+							+		Ns					+	Ns	
Experience - Host Country			+	+			+									+	+ -
Experience – Mode															+		
Experience – Product																	Ns
Transaction Variables																	
Reputation																	+ -
Asset Specificity	+						Ns	Ns		Ns	+				Ns	+	+

Source: Adapted from Bell (1996: 32-33)

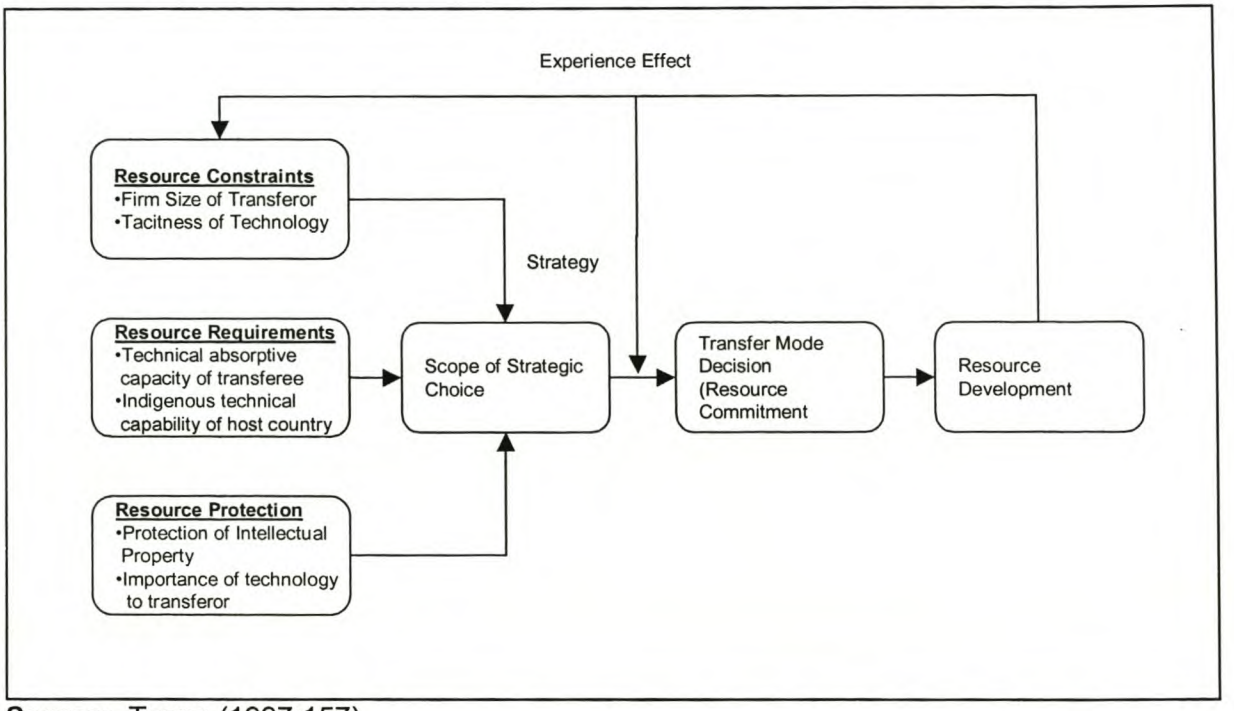
5.2.4 Criticism of Current Entry Mode Decision Models.

Although useful, the models offered to guide entry mode choice can be criticised mainly on two fronts. The first point of critique is that most of the models are viewed only from one or a few theoretical frameworks. The transaction cost framework and resource-based view only view the entry mode decision within the parameters of its narrow theoretical departure points. The transaction cost framework are limited to the cost of the transaction. The resource-based view neglects costs, strategic- and institutional determinants.

The second point of criticism relates to the work of Bell (1996). Bell (1996) provided the most comprehensive entry mode framework by integrating the transaction cost-, internalisation-, strategic behaviour- and resource-based views into a framework for entry choice. However, firstly, the empirical work of Bell was limited to Dutch companies, thus limiting the ability to generalise the results. Secondly, Bell's (1996) classifications of resource-based variables. Although experience can be seen from a resource-based

perspective, Bell neglects the heart of ownership advantages, namely the level of intellectual property transferred by the firm. Thirdly, and more importantly Bell did not include institutional and evolutionary variables in his model. Lastly, the work of Dunning (1981, 1988, 1989, 1995) relating ownership advantages (Ot & Oa) can be extended to include Oe or ownership experience determinants. Oe variables can be regarded as evolutionary variables.

Figure 37: A Model of International Technology Transfer Mode Choice



Source: Tsang (1997:157)

5.2.5 An Integrated Market Entry Mode Decisions Framework for Foreign Investors

From the literature review up to this point, it is clear that authors use entry mode determinants inconsistently, resulting in uncertainty where exactly each determinant fits in. It is helpful to understand that the determinants of entry mode choice can be classified either by the unit of analysis or per its theoretical foundation as illustrated in Table 15. Moreover, it is important to note that each unit of analysis can be analysed from different theoretical perspectives. For instance the firm can be analysed from strategic-, resource-based or internalisation perspectives.

In order to logically analyse the entry mode decision the unit of analysis should be considered from the macro to the micro. As proposed in Figure 38 , the foreign entrant considering the entry mode choice should first perform an external analysis in which it

considers the home-, host- and industry factors from a location- and institutional perspective. Secondly, the entrant should consider the firms internal environment from a strategic-, resource-based- and an ownership experience (evolutionary) perspective. Lastly the potential partner, project and the transaction should be analysed from a resource-based- and transaction cost perspective. Upon considering each of these determinants, depending on its relative weight the entrant will be in a good position to choose the level of ownership to adopt in the FIE.

Based on the framework in Figure 38 the impact of each determinant on the level of ownership in a FIE will be reviewed in the subsequent sections of this chapter.

Table 15: A Logical Analysis of Entry Mode Choice

Unit of Analysis		Theoretical Perspective of Analysis
External Analysis	Host Country	• Location Advantage • Institutional Theory
	Home Country	• Location Advantage • Institutional Theory
	Industry	• Strategic Behaviour View • Resource-based View • Transaction Cost
Internal Analysis	Firm	• Strategic Behaviour View • Resource-based View • Ownership Advantages
Transaction Analysis	Partner	• Resource-based View • Transaction Cost
	Project	• Resource-based View • Transaction Cost
	Transaction	• Transaction Cost View

5.3 Location Determinants of Entry Mode Choice

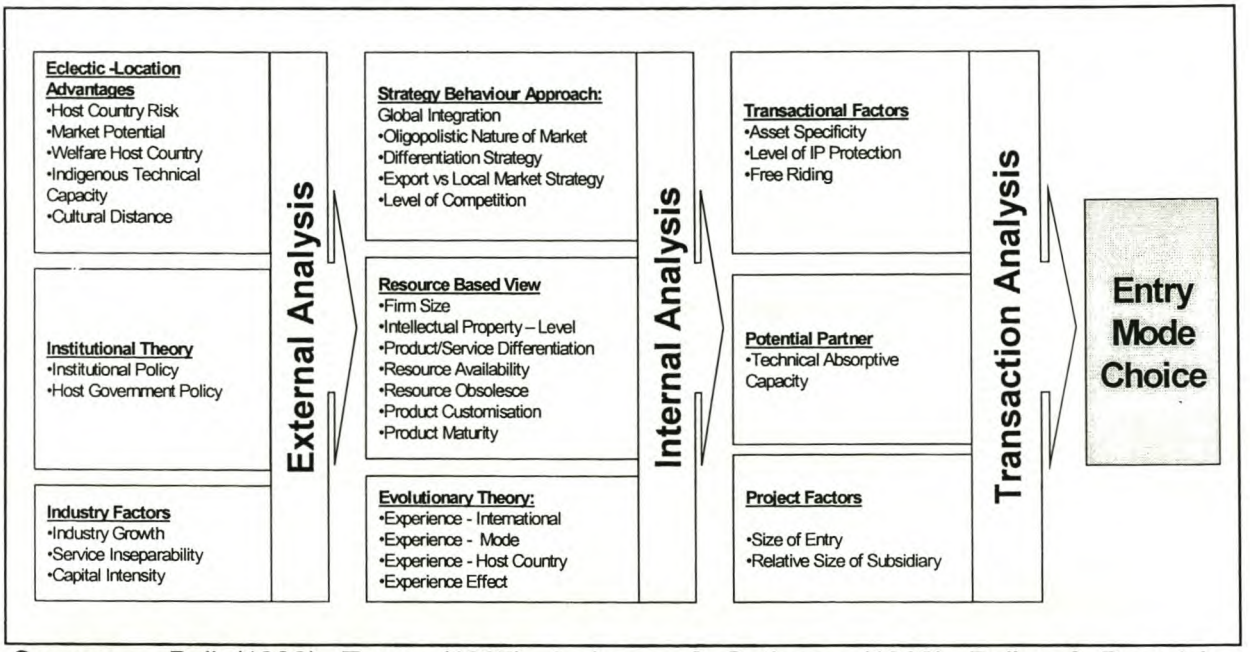
Depicted in Figure 38 are the location determinants that need consideration as part of the external analysis. The determinants are host country risk, market potential of the host country, level of welfare in the host country, indigenous absorptive capacity of the host country and the social cultural distance between the home and the host country.

5.3.1 Host Country Risk

Drawing on a number of writers, Anderson & Gatignon (1986) include as host country risk political instability, economic fluctuation and currency changes. They offer that one response

to country risk is to exert more control over an operation, but caution that from a transaction cost perspective such an attempt might lock an entrant into a relationship that will result in obsolete technology. A second response to a high country risk is to utilise lower control modes. However, when asset specificity is high, a magnifying effect takes place due to the specificity of an investment. High asset-specificity companies will find it too venturesome to be at the mercy of partners (in a volatile external situation) and prefer higher control mechanisms. Consequently 'the greater the combination of country risk (political instability, economic fluctuations) and transaction-specificity of assets, the higher the appropriate degree of control will be exerted' (Anderson & Gatignon 1986: 15).

Figure 38: An Integrated Market Entry Mode Decision Framework for Foreign Investors



Sources: Bell (1996), Tsang (1997), Anderson & Gatignon (1986), Delios & Beamish (1999)

Bell (1996) on the other hand established that country risk alone, negatively affects ownership level (increase likelihood of JV's). Table 14 evinces that the studies of Gatignon & Anderson (1988) and Shane (1993) supported findings of Bell, while those of Agarwal and Ramaswami (1992b) and Brothers et al. (1993) contradict the current study. Bell (1996) maintains that firms will seek to reduce ownership levels in a high-risk country since it offer firms more flexibility and at least losses will be shared.

Proposition 1: Host Country Risk (a)

All things being equal, increased host country risk will amplify a MNC's desire for flexibility of movement and hence reduce the levels of ownership in a FIE.

Proposition 2: Host Country Risk (b)

All things being equal, increased host country risk will enlarge the desire to control an investment, especially when asset specificity is high. Subsequently greater ownership levels will be sought in a FIE.

5.3.2 Market Potential

No study was discovered that specifically researched the impact of market potential. Firms entering high market-potential countries can be expected to be more willing to invest greater amounts in view of the potentially larger return. In addition, higher potential markets will attract more foreign investors.

Proposition 3: Market Potential

All things being equal, host countries with relatively larger market potential will provide foreign investors with the incentive to commit more resources and consequently take higher ownership levels in a FIE.

5.3.3 Level of Welfare

Bell (1996) studied how the level of welfare in the host country affects the level of ownership. He found that an increase in the level of welfare will have a negative impact on the level of ownership adopted in a FIE. The findings of Bell (1996) are supported by the findings of Gomes-Casseres (1989,1990), Shane (1993) and Argwal (1994). Larimo (1993) in contrast found the opposite (see Table 14). Bell (1996) justifies that firms are much more willing to enter developed countries than developing countries since the local firm have much more to offer in terms of expertise and local market knowledge.

Proposition 4: Level of Host Country Welfare

All things being equal, MNC's entering host countries with a relatively high welfare will be more likely to utilise joint ventures than entering host countries with a lower level of welfare.

5.3.4 Indigenous Technical Capability (ITC)

Indigenous technical capability refers to the ability of the country to assimilate technology. R&D expenditures, investment in national education, and the number of technical personnel per capita provide indications of the ITC. Tsang (1997) highlights the finding of Contractor (1980) that in developing countries with a higher ITC, a higher proportion of licensing as means of technology transfer exist. Consequently, 'when the indigenous technical capability of the host country is low, firms will prefer transfer modes that require high resource commitment' (Tsang 1997: 160).

Proposition 5: Indigenous Technical Capability

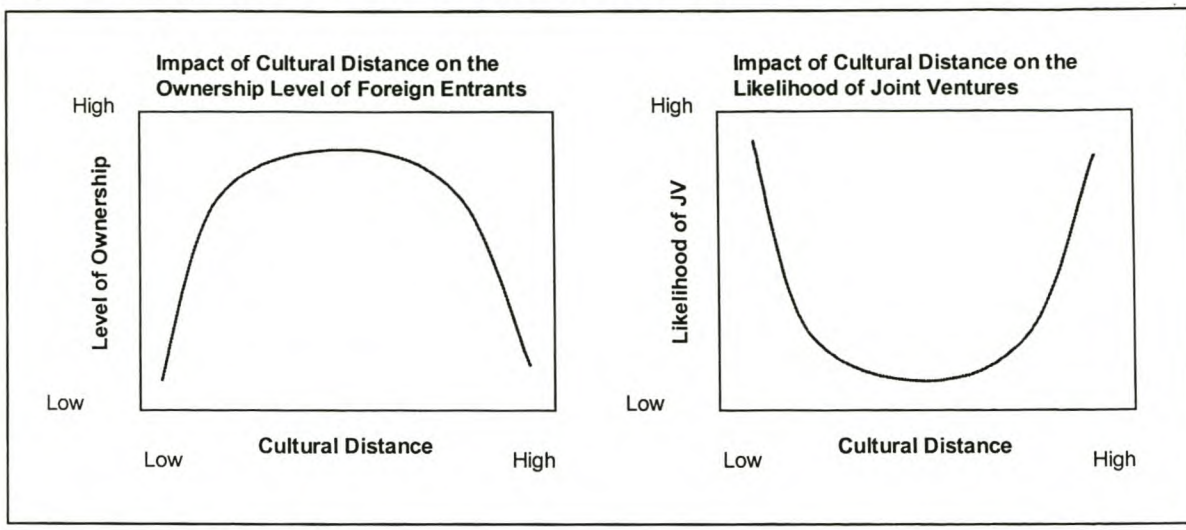
All things being equal, when the indigenous technical capability of the host country is low, the foreign investor will more likely prefer higher ownership levels. Whereas an increased ITC will reduce the need for high ownership levels in a FIE.

5.3.5 Cultural Distance

According to Anderson & Gatignon (1986) when the socio-cultural distance between a home- and host country increases, internal uncertainty forms within the firm. The writers propound that at high levels of socio-cultural distance, low control levels are more efficient than intermediate levels and high-control levels are more efficient than intermediate levels. 'High-control levels are more efficient only when there is a substantial advantage to doing business in the entrants way' (1986:18).

Bell (1996) denotes that studies regarding the impact of cultural distance on the likelihood of JV's/ WFOE's are contradictory. Table 14 reveals that a group of studies found that cultural difference negatively influences the level of ownership of foreign entrants (Gatignon and Anderson: 1988; Erramilli: 1991; Agarwal and Ramaswami: 1992b; Erramilli and Rao: 1993, Argwal: 1994). On the other hand, Madhok (1994) and Padmanabhan (1994) observed that cultural difference enhances the likelihood of full ownership modes being used by entrants. The study of Bell (1996) is the first to clarify this apparent contradiction by observing both a positive and negative effect on ownership as depicted in Figure 39.

Figure 39: Impact of Cultural Distance on Ownership Level



Source: Bell (1996: 107)

At very low and very high levels of cultural difference, firms will prefer lower ownership modes. The likelihood of JV's during these levels of cultural distance will be high. This trend may indicate that firms select joint ventures for different reasons, and it may be in culturally similar or -diverse host countries. At very high levels of cultural difference, companies will associate in joint ventures, as a means of getting acquainted with host cultures. Joint research, learning or sharing of costs are motives for joint ventures in lower cultural distance companies (Bell: 1996).

Proposition 6: Cultural Distance

All things being equal, at very low and very high levels of cultural distance MNC's espouse lower levels of ownership, whereas at moderate levels of cultural distance MNC's will favour greater levels of ownership in a FIE.

5.4 Institutional Determinants of Entry Mode Choice

5.4.1 Internal Institutional Policy

Davis (2000: 239-259) offers an isomorphism perspective on entry mode choice within a institutional framework. He criticises the transaction cost and resource-based framework as being inconsistent and contradictory in findings.

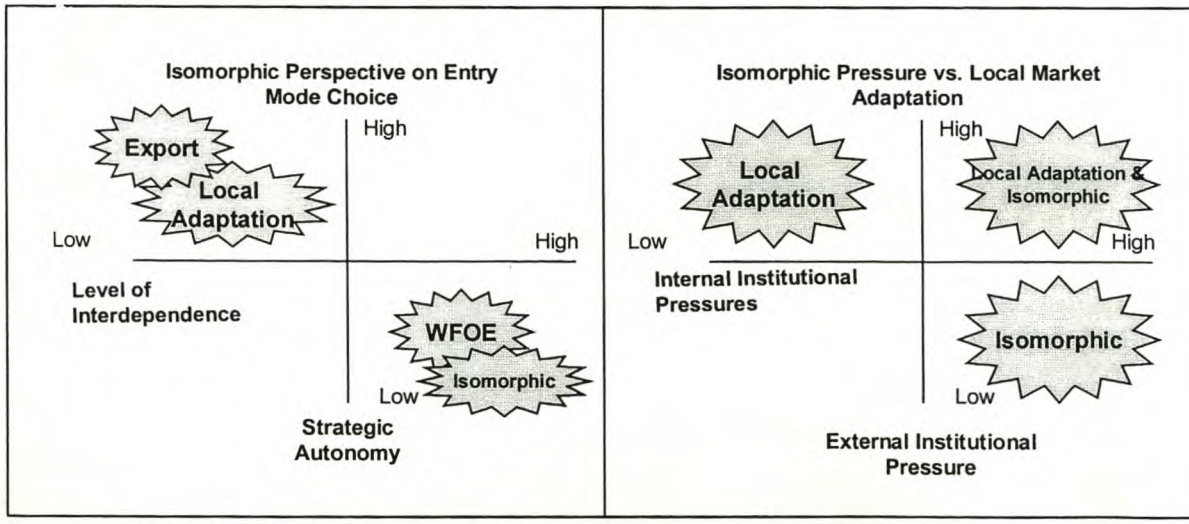
Institutional theory comprises both external and internal institutions in its definition. External institutions include regulatory structures, agencies, laws, courts and professions. Internal

institutions may include institutional pressures within the parent firm. Subsidiaries or strategic business units need to conform to the parent's organisational norms. Subsequently two sources of isomorphic pressure need consideration when dealing with entry mode: host country institutional environment and internal (parent) institutional environment. To achieve legitimacy with other organisations, such as host country government or the parent firm, a strategic business unit must conform to institutional pressures whether internal or external. The focal point to gain legitimacy can be either internal or external. The relative dominance of internal vs. external institutional pressure will determine organisational behaviour.

Parent organisations maintain similarity across subsidiaries through organisational structures, processes and routines. As a parent increases control in a subsidiary, the pressure to maintain internal isomorphism may override pressure for external isomorphism. Alternatively, when a subsidiary enjoys a high level strategic autonomy, the pressure to conform to internal isomorphism may reduce.

A higher degree of interdependence or resource sharing between a subsidiary and a parent will increase the need for control and co-ordination and consequently the greater the need for internal isomorphism (similarity). As illustrated in Figure 40, Davis (2000) found that business units utilising WFOE's have experienced a higher degree of parent isomorphism than other business forms. When the level of interdependence between parent and subsidiary is high, and the strategic autonomy is low, the likelihood of utilising a WFOE is greater.

Figure 40: An Isomorphic Perspective on Entry mode Choice



Source: Compiled from Davis (2000: 239-259)

Local market adaptation exists when the external institutional pressures are higher than the internal institutional pressure. In other words, the subsidiary will rather conform to and gain legitimacy from host country institutions. Lower resource commitment modes are utilised under local adaptation, for example exporting or licensing.

Proposition 7: Internal Isomorphic Pressure

All things being equal, MNC's with a high level of internal isomorphic pressure will be more likely to opt for full-control entry modes.

Proposition 8: Local Adaptation

All things being equal MNC's with a high level of local adaptation will be more likely to utilise share-control entry modes.

5.4.2 Host Government Policy / -Restrictiveness

Host country restrictiveness refers to restrictions that a host government imposes on foreign entrants. Especially restrictions related to the ownership levels allowed in a FIE. Bell (1996) found a non-significant effect of host government policy contrary to all the previous studies of Gatignon and Anderson (1988), Gomes-Casseres (1989), Gomes-Casseres (1990), Shane (1993), and Padmanabhan (1994) (See Table 14). He expostulates that much earlier data sets (between 1965 and 1986) were utilised. In addition, he submits that Padmanabhan and Cho's (1994) study contrasted two data sets, entries before 1986 and entries after 1986. Host government restrictions influenced ownership level much more before 1986 than in the second period (Bell 1996: 108). On the other hand, Delios & Beamish (1999) observed that host country restrictions have a significant negative impact on the ownership structure of foreign entrants. They also found a strong correlation between host country risk and host country restrictiveness.

Proposition 9: Host Government Restrictions

All things being equal, MNC's entering a host country with restrictive government policies on ownership level will deter from utilising full-control entry modes

5.5 Industry Determinants of Entry Mode Choice

5.5.1 Industry Growth

Bell (1996) found that high industry growth would encourage the formation of joint ventures. This finding is consistent with Erramilli (1991). A JV may be perceived as a better vehicle to capture opportunities of fast growing industries since a JV can be faster operational than a Greenfield WFOE.

Proposition 10: Industry Growth

All things being equal, MNC's entering fast growing industries will tend to utilise lower ownership structures like joint ventures to exploit fast dawning opportunities.

5.5.2 Service Inseparability

Erramilli & Rao (1993) drawing on a number of writers distinguish separable services from inseparable services. Separable services' production and consumption can be de-coupled. For instance an engineer can perform his design work in a home country and send the design to the host country. However, for inseparable services such as the hotel service or hospitals, the service is consumed as it is produced. In inseparable service, the foreign entrant will need to take much care to ensure that the service is rendered according to standard. It will therefore require attention that is more personal. Consequently, inseparable services require higher levels of control over the operation.

Proposition 11: Service Inseparability

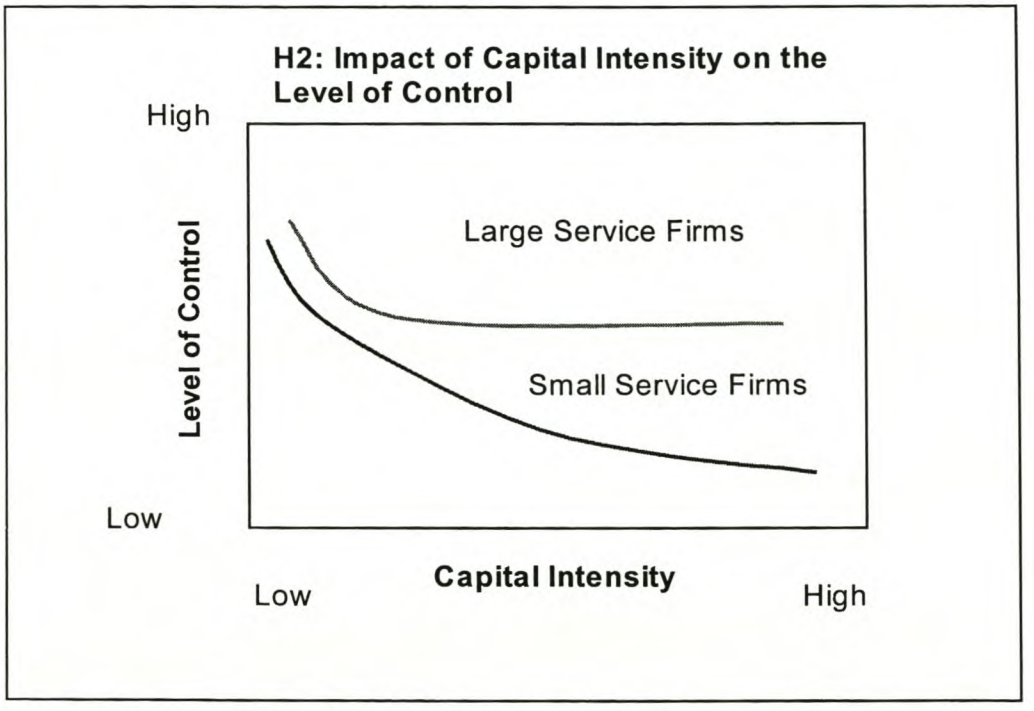
All things being equal, MNC's entering an industry characterised by inseparability of service, will be more likely to employ higher ownership levels in the FIE.

5.5.3 Resource/Capital Intensity

Erramilli & D'Souza (1993: 29-42) contrasts the foreign market entry behaviour of small firms with that of large firms. Drawing on a number of studies, they suggest that small firms be characterised by resource constraints and cautious investments. Larger companies on the other hand tend to choose high-resource, high-risk entry modes. Full-control entry modes become less likely as the scale of foreign operation increases.

Employing a mail survey of US service companies, Erramilli & D'Souza (1993) studied the impact of capital intensity on the entry mode choice of small and large service firms. Figure 41 depicts at low levels of capital intensity, that both small and larger service firms will adopt high levels of ownership. At a higher capital intensity, small service firms yield more control than larger service firms do. Small service firms lack the ability to commit resources and perceive greater risk than larger firms do. The capital intensity of the industry, to which it belongs, conditions the relationship between firm size and foreign market entry behaviour of the firms.

Figure 41: The Impact of Capital Intensity on ownership levels in FIE's



Source: Compiled from Erramilli & D'Souza (1993)

Proposition 12: Resource/Capital Intensity

All things being equal, MNC's entering into a high resource or capital intense industry, will be more likely to utilise lower ownership levels in the FIE.

Proposition 13: Capital Intensity and Service Firms

All things being equal, small service firms entering a high capital intense industry, yield more control than large service firms will.

5.6 Strategic Determinants of Entry Mode Choice

5.6.1 Global Integration vs. a Multi-Domestic Strategy

Hill et al. (1990) proposes that one of the crucial choices a firm needs to make in the context of strategy, is whether to adopt a global or multi-domestic strategy. A multi-domestic strategy is adopted in the belief that markets differ in 'consumer tastes, competitive conditions, operating conditions, political-, legal- and social conditions' (1990: 120). To maximise value (differentiate) companies must be responsive to local demand. Responsiveness will imply the development of an own marketing function, autonomous manufacturing, differing product attributes and differing competitive strategies in each host country.

A global strategy capitalises on the belief that a convergence of tastes or needs in the global markets exist, leading to homogeneous global markets. Global markets can be exploited through economies of scale, centralised production and -marketing (cost advantage). In a global strategy, the value chain will be configured to manufacture a component or part at the best possible location. Then the final product is assembled locally to make small adjustments if so required. To follow a global strategy, requires a high degree of control in order to attain co-ordination in the global production system.

Bell (1996) confirms that when a firm follows a global strategy it will decrease the likelihood of a JV (and increase the likelihood of a WFOE). Although the findings of Bell show a positive relationship with level of ownership, it was not significant. No previous studies tested the impact of global strategy on level of ownership. Further research of the role of a global strategy is required.

Proposition 14: Global Strategy vs. Multi-Domestic Strategy

All things being equal, MNC's that follow a global strategy will adopt higher ownership levels in a FIE than those who follow a multi-domestic strategy.

5.6.2 Oligopolistic Nature of Market

Hill et al. (1990) also observes with an increasing number of industries that are oligopolistic in nature, companies have objectives that go beyond normal calculus of choosing the most efficient entry mode for the market. It may well enter a host country with the aim of deterring an international competitor from attacking its home market. Especially in global oligopolies,

the need for global co-ordination is high and it will utilise full-control entry modes even when it does not make economic sense on stand-alone basis.

Proposition 15: Oligopolistic Nature of Market

All things being equal, MNC's entering in an oligopolistic market will adopt a higher level of ownership in a FIE than those who do not enter an oligopolistic market.

5.6.3 Differentiation Strategy

Argwal et al. (1992) found that firms following a differentiation strategy (or have a higher ability to differentiate products) are averse to contractual risk and prefer investment entry modes. In other words, firms that follow a differentiation strategy have a higher level of intellectual property and react in the same way as firms with a high intellectual property level. See 5.7.2 for a discussion on the impact of intellectual property level of entry mode choice.

Proposition 16: Differentiation Strategy

All thing being equal, MNC's that follow a differentiation strategy will adopt higher ownership levels in a FIE than MNC's who follow a low cost strategy.

5.6.4 Local vs. Export Market Focus

Foreign entrants exploiting a host country as an export base, can be expected to be less concerned with local market adaptation or knowledge and access to the local market. However, entrants with a local market focus will require local market knowledge and local markets access - gained through partnership. Consequently firms with a local market focus will be more likely to collaborate with local firms, thus reducing the ownership level adopted in the FIE (Pan & Chi: 1999).

Proposition 17: Local vs. Export Market Focus

All things being equal, MNC's with a primary focus on the host country market will likely favour a joint venture with a local partner, than a MNC who employs an export strategy.

5.6.5 Level of Competition

A high level of competitive intensity may reduce the attractiveness of a particular market and therefore reduce the incentive to employ high-resource commitment entry modes in a foreign market. However, Bell (1996) found, contrary to the proposition that strong competition will increase the likelihood of a JV (decrease the likelihood of a WFOE), that stronger competition decreased the likelihood of JV's. The finding implies that MNC's require more control over a FIE to handle the competitive situation more effectively. Previously only Kogut & Singh (1988) detected the non-significant impact of competition.

Proposition 18: Level of Competition

All things being equal, MNC's entering a market with a high competitive intensity, will require a greater level of ownership to manage the FIE.

5.7 Resource-Based Determinants of Entry Mode Choice

5.7.1 Firm Size of the Transferor

Tsang (1997) suggests that resource constraints include both quantity and quality of resources. The size of the transferor relates to quantity of resources. For instance, the number of employees limits how fast a transfer can be done. Even if new employees are appointed, time is necessary to become part of the organisation and to learn organisational processes. Another constraint is financial resources or a lack of capitalisation, which limits the options for greater control. Therefore 'when compared with large firms, small firms will favour transfer modes that require low resource commitments' (1997:159).

Proposition 19: Firm Size of Transferor

All things being equal, large MNC's, with high resource availability, are more likely to utilise full-control entry modes, than small firms with less resources.

5.7.2 Level of Intellectual Property

Regarding the quality of resources, Tsang (1997) suggests that the tacitness of the knowledge will determine the level of intimate human contact required for the transfer. Drawing on a number of authors, Tsang (1997) states 'the newer the technology, the more a firm will favour transfer modes that require high resource commitments' (1997:159). Also

drawing on a number of studies, Tsang (1997) proposes that 'the more complex technology, the more a firm will favour transfer modes that require high resource commitments' (1997:159).

Proposition 20: Intellectual Property Level (a)

All things being equal, MNC's transferring high levels of intellectual property will be more likely to pursue full-control entry modes as opposed to a firm transferring lower levels of intellectual property.

5.7.3 Intellectual Property Rights Protection

Consistent with Das (2000), Tsang (1997) suggests that firm resources are imperfectly imitable. However, when technology is substantially coded, imitation by a competitor can be a real danger. It is critical that a firm protects itself against leakage of its expertise. The risk of patent infringement will provide an incentive for firms to seek higher control or complete internalisation. Hence, 'when the protection of intellectual property rights is poor in the host country, firms will favour transfer modes that require high resource commitments' (Tsang 1997: 161).

Similarly, Anderson & Gatignon (1986) caution against free riding. Free riding refers to agents that receive benefits without paying the costs. McDonalds for example experienced problems with some of its franchises that attracting customers based on its name. The free riders however did not uphold the stringent rules that accompany the franchise. In other words, free riding is the danger of a brand name utilised inappropriately, inconsistently or wrongly positioning it. The more valuable the brand name, the higher control over the operation will be required. Therefore 'entry modes offering higher degrees of control are more efficient the higher the value of brand name' (Anderson & Gatignon (1986: 20).

Delios & Beamish (1999) discovered that protection of intellectual property would instigate a negative relationship with ownership structure. Consequently, when intellectual property protection is weak, firms will aim to protect itself against the leakage of information by acquiring a higher ownership level of the new subsidiary.

Proposition 21: Intellectual Property Rights Protection

All things being equal, MNC's entering a host country with weak intellectual property protection, will be compelled to obtain high levels of ownership in a FIE.

5.7.4 Importance of Technology

The role that technology plays in the transferor's business will determine what level of protection will be required. Drawing on a number of authors, Tsang (1997) suggests that a higher R&D investment level and closeness of technology to the core business (or competitive advantage) will increase the need for protection. Accordingly 'the more important the technology is to a firms business, the more the firm will favour transfer modes that require high resource commitments' (1997: 161).

Proposition 22: Importance of Technology Transferred

All things being equal, the greater the importance of the technology transferred to the transferor, the higher the level of ownership that a MNC will adopt in a FIE.

5.8 Evolutionary Determinants of Entry Mode Choice

5.8.1 International Experience

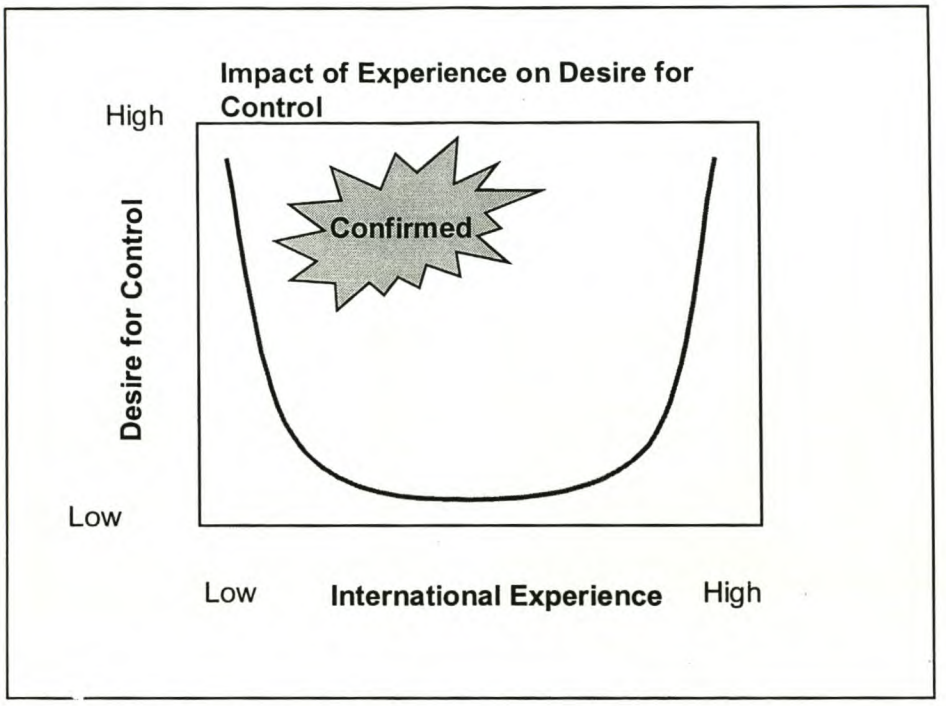
Anderson & Gatignon (1986: 17) propose that the 'degree of control in a foreign business entity should be positively related to the firms cumulative international experience'. Inexperienced international entrants fear the unknown, overstate risks, and understate opportunities. These firms also choose culturally similar countries to invest. As experience increases competence, confidence and understanding increases and investments flow to countries that are culturally more distant. An increase in experience leads to greater control.

Erramilli (1991: 479–502) examines the effect of international experience on service firms' selection of entry modes and points to the apparent contradiction in research on the impact of experience on the mode choice. Erramilli (1991) suggests ethnocentric and polycentric explanations for the impact of international experience on entry mode choice. The ethnocentric explanation holds that parent companies insist that their own employees will manage the new subsidiary since the host country workers cannot be trusted. An ethnocentric view requires full ownership of the new venture. Secondly, the polycentric view proposes that as experience in the host country increase, companies realise that local employees can profitably be utilised and control can be relaxed.

Illustrated in Figure 42 he proposes that a U-shaped relationship between experience and desire for control exist. Between low to moderate levels of international experience, the

desire for control will decline, whereas between moderate to high levels, it will increase. Companies with much experience will reason that they do not need partners anymore since they know the market and are able to exploit opportunities themselves.

Figure 42: Impact of International Experience



Source: Compiled from Erramilli (1991: 479-502)

Employing a mail survey of US service firms engaged in international operations, international experience is measured both in length (number of years engaged in international operations), as well as scope (geographical location) of business activities. The findings confirmed that the probability of service firms choosing full-control modes is high at low levels of experience, low at moderate levels and again high at high levels of experience. However, contrary to market selection results, the length and not scope of experience seemed to be important in determining entry mode choice.

Bell (1996) observes a positive impact of international experience on level of ownership. Earlier studies of Gatignon and Anderson (1988), Agarwal and Ramaswami (1992a) and Madhok (1994) support the observation (See Table 14). As companies gain international experience, they become more comfortable with entering cultural diverse situations and desire greater control of their operations.

Proposition 23: International Experience (a)

All things being equal, at lower levels of international experience, MNC's desire high levels of ownership, however the desire for control will gradually decrease as they gain experience.

Proposition 24: International Experience (b)

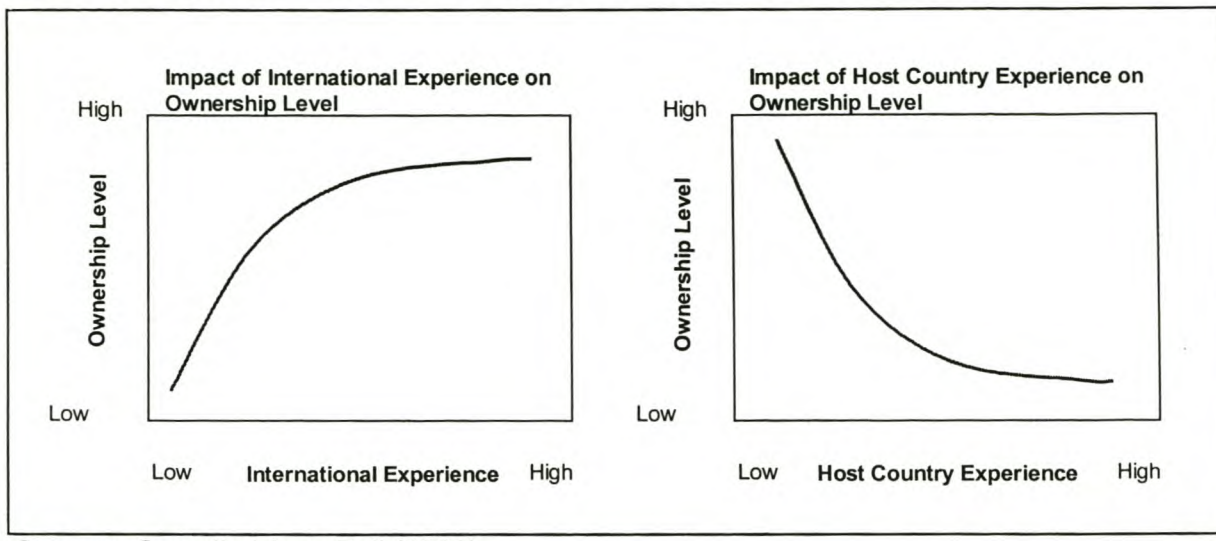
All things being equal, at higher levels of international experience, MNC's will desire and be more equipped to take greater levels of control of their foreign operations.

5.8.2 Host Country Experience

Contrary to the proposition that higher host country experience decrease the likelihood of JV's, Bell (1996) found that it 'significantly increases the probability of JV's as compared to WFOE's' (1996: 104). His finding is in contrast with his own findings of international experience as discussed in 5.8.1. Moreover, the studies of Gomes-Casseres (1989), Gomes-Casseres (1990), Hennart (1991), and Padmanabhan (1994) found a positive impact of international experience on entry mode. Bell (1996) suggests that different dynamics be at work with host country experience as opposed to international experience. As host country experience increase, firms learn that it can profitably to operate alongside local companies, or they realise that they need local partners.

Delios & Beamish (1999) measure international experience by means of export intensity, number of foreign investments and the years of host country experience. Both an increase in export intensity (a proxy for international experience) and host country experience resulted in higher levels of ownership, thus contrasting Bell's findings as illustrated in Figure 43.

Figure 43: Impact of International Experience vs. Host Country Experience



Source: Compiled from Bell (1996)

Erramilli (1991) did not separate host country experience from international experience when he found a U-shaped relationship of international experience on ownership level. It is possible then to suggest that the cumulative effect of both host country and international experience render the U-shaped outcome. The work of Bell (1996) should be examined for a possible U-shaped effect of host country and international experience.

Proposition 25: Host Country Experience (a)

Ali things being equal, an increase in host country experience will reduce the fears for co-operation in joint ventures and will increase the likelihood to exploit strategic opportunities by means of shared ownership.

Proposition 26: Host Country Experience (b)

All things being equal, an increase in host country experience will lead to a greater desire for control over the foreign subsidiary, resulting in an increased likelihood of adopting full-control entry modes.

5.8.3 Mode Experience

Although Bell (1996) proposes that both JV experience and WFOE experience positively affect the likelihood of the respective entry modes, his study encountered multi-collinearity problems and omitted these two variables from the study. Madhok (1994) found a positive relationship with mode experience. Tsang (1997) proposes that 'the efficiency of handling a

transfer mode will be positively related to the number of times that the mode has been used' (1997: 164).

More recently Padmanabhan & Cho (1999: 25-44) examined the impact of mode specific experience on the ownership level of FIE's. Drawing on various authors, Padmanabhan & Cho (1999) state that decision specific experience is gained though being part of a particular decision setting which then becomes ingrained in the organisational memory. Decision specific experience can be considered as important sources of ownership assets and transaction advantages to the firm.

Their study of Japanese FDI confirmed their propositions (see Figure 44). Firms with a high level of experience in a particular mode, will utilise that mode more frequently. For example, firms with much JV experience will be more likely to enter new markets by utilising a JV. Moreover, mode specific experience is more influential than international or host country experience in determining the subsequent ownership structures of new market entries.

Proposition 27: Mode Experience (a)

All things being equal, MNC's with a higher level of share-control mode experience, will be more likely to employ share-control entry modes.

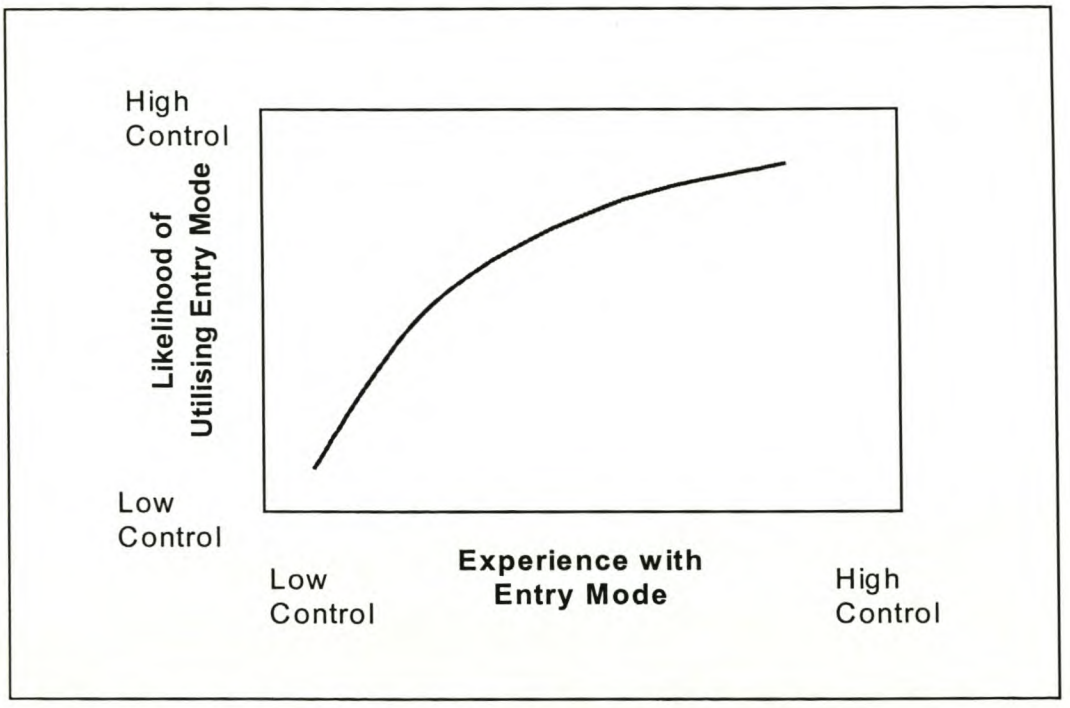
Proposition 28: Mode Experience (b)

All things being equal, MNC's with a higher level of full-control entry mode experience, will be more likely to employ full-control entry modes.

Proposition 29: Mode Experience (c)

All things being equal, a high level of mode experience will be more influential in determining the entry mode choice than host country or international experience.

Figure 44: Impact of Decision Specific Experience on Entry Mode Choice



Source: Compiled from Padmanabhan & Cho (1999: 25-44

5.8.4 Product Experience

Bell (1996) found that a company's experience with a product or service does not affect the likelihood of JV significantly. The study does not support the proposition that sufficient product experience decreases the likelihood of JV's. No previous studies measured product experience.

5.8.5 Experience Effect

Tsang (1997) points to the surge in literature concerning the learning organisation over the past decade. A learning organisation modifies, adapts and improves behaviour with the gaining of experience. Referring to a number of studies, Tsang (1997) asserts that as firms enter countries they gain experience that will result in lower cost of subsequent entries. Moreover, firms learn more from utilising higher resource commitment modes than those utilising lower resource commitment modes. Therefore, 'the cost of transferring a technology will be negatively related to the number of prior transfers. The experience effect will be more pronounced if the prior transfer modes require high resource commitments' (1997: 163).

With the transfer of technology, modifications of the technology are necessary. For example, equipment that operates well in cold weather will not operate well in tropical weather.

Modifications or innovations might spark brand new innovations. The probability of these innovations will increase with an increase in the number of technology transfers (Tsang: 1997).

5.9 Transactional Cost Determinants of Entry mode Choice

5.9.1 Asset Specificity

Anderson & Gatignon (1986: 7) define transaction-specific assets as 'investments (physical and human) that are specialised to one or a few users or uses'. The default hypothesis in the transaction cost analysis (TCA) is that a low level of ownership should be utilised until proven otherwise. The TCA further suggests that firms should not integrate when the supplier market is competitive. Competition leads to effective market functioning. By not integrating, companies avoid the cost of company divisions, -politics and inefficiencies. However, when a transaction-specific advantage becomes valuable, the TCA suggests that it is better to integrate (internalise) the operation or alternatively redesign the task in order that general-purpose assets can service the operation. Four types of transaction-specific assets are identified:

Firstly, proprietary products. 'Modes of entry offering greater control are more efficient for highly proprietary products or processes' (Anderson & Gatignon 1986: 10). It is difficult to transmit non-codified products or services across borders. Valuation of information becomes a problem when the buyer or agent does not know what the value of information is without the supplier revealing it, at which point the information loses its value. Thus, owners of proprietary knowledge will exploit it by means of direct investment.

Secondly, unstructured products. 'Entry modes offering higher degrees of control are more efficient for unstructured, poorly understood products and processes' (Anderson & Gatignon 1986: 11).

Thirdly, the custom made level of a product. 'Entry modes offering higher degrees of control are more efficient for products customised to the user' (Anderson & Gatignon 1986: 11). Customisation of products demands a high level of dependence on local knowledge. A growing dependence on a contractor for such local knowledge implies high asset specificity, and consequently a company will be locked in. A firm would therefore want to internalise the function.

Fourthly, the product maturity. 'The more mature the product class, the less control firms should demand of a foreign business entity (Anderson & Gatignon 1986: 12)'. Immature products are undefined and knowledge and expertise still embedded in the employees working with the products. In an effort to avoid leakage of knowledge, firms will have a desire to utilise a high level of control. However, when product knowledge diffuse and become standard, the incentive to use low control low risk methods to reap income will increase (Anderson & Gatignon: 1986).

Bell (1996) also finds that extraordinarily specific assets decrease the likelihood of JV's (increase likelihood of WFOE's). Gatignon and Anderson (1988), Erramilli and Rao (1993) and Padmanabhan (1994) as highlighted in Table 14 support his findings.

Proposition 30: Product Customisation

All things being equal, MNC's that enter a market with a high level of product customisation, will be required to take a high level of ownership in a FIE.

Proposition 31: Life Cycle Stage

All things being equal, MNC's with mature and defined technology can gain an 'extra mile' through adopting low resource commitment entry modes.

Proposition 32: Asset Specificity

All things being equal, MNC's with high levels of transaction-specific assets, will obtain higher ownership levels in a FIE due to the high cost of switching between partners

5.9.2 Asset Specificity in the Service Sector

Eramilli & Rao (1993: 19-38) study the choice of entry modes by contrasting patterns between low and high asset specificity in US service firms. They argue that the application of the TCA approach to service-firms proved some shortcomings. The basic assumption of the TCA is that companies prefer low-control modes. Eramilli & Rao (1993) however protest that the default choice would be a preference for higher control modes. In addition, numerous non-TCA motives for integration of activities exist. For example, the existence of a global strategy, co-operation requirements, larger profits, and avoiding disadvantages of shared control. Integration costs are not always that high for service firms whom normally do

not have the same expensive plants and equipment. Consequently, the modified transaction cost approach (MTCA) assumes that a company's default preference is for a higher level of control. The benefits of integration for high specificity are so high that they will shun away from shared control in virtually all situations.

Asset specificity in the service industry relates to idiosyncratic services. Defined as services which are characterised by high levels of professional skills, specialised knowledge and customisation. Professional skills are acquired through many years of study and experience, and require significant levels of assets and human investments. Specialised expertise refers to knowledge that is specific to a very narrow range of applications and which is not of much use elsewhere (e.g. management consulting in the health care industry). The level of customisation to individuals contributes to the specificity of the investment. The marketing of idiosyncratic services are characterised by high asset specificity and it will be difficult to transfer the service to someone else to render.

The MTCA predicts that a firm's utility for shared-control modes diminishes with increasing asset specificity. However capital intensity, inseparability of service, cultural distance and host country risk may act as moderators to the effect of asset specificity. Utilising a mail survey of US service firms, the inverse relationship of the following moderating factors were studied (see Figure 45):

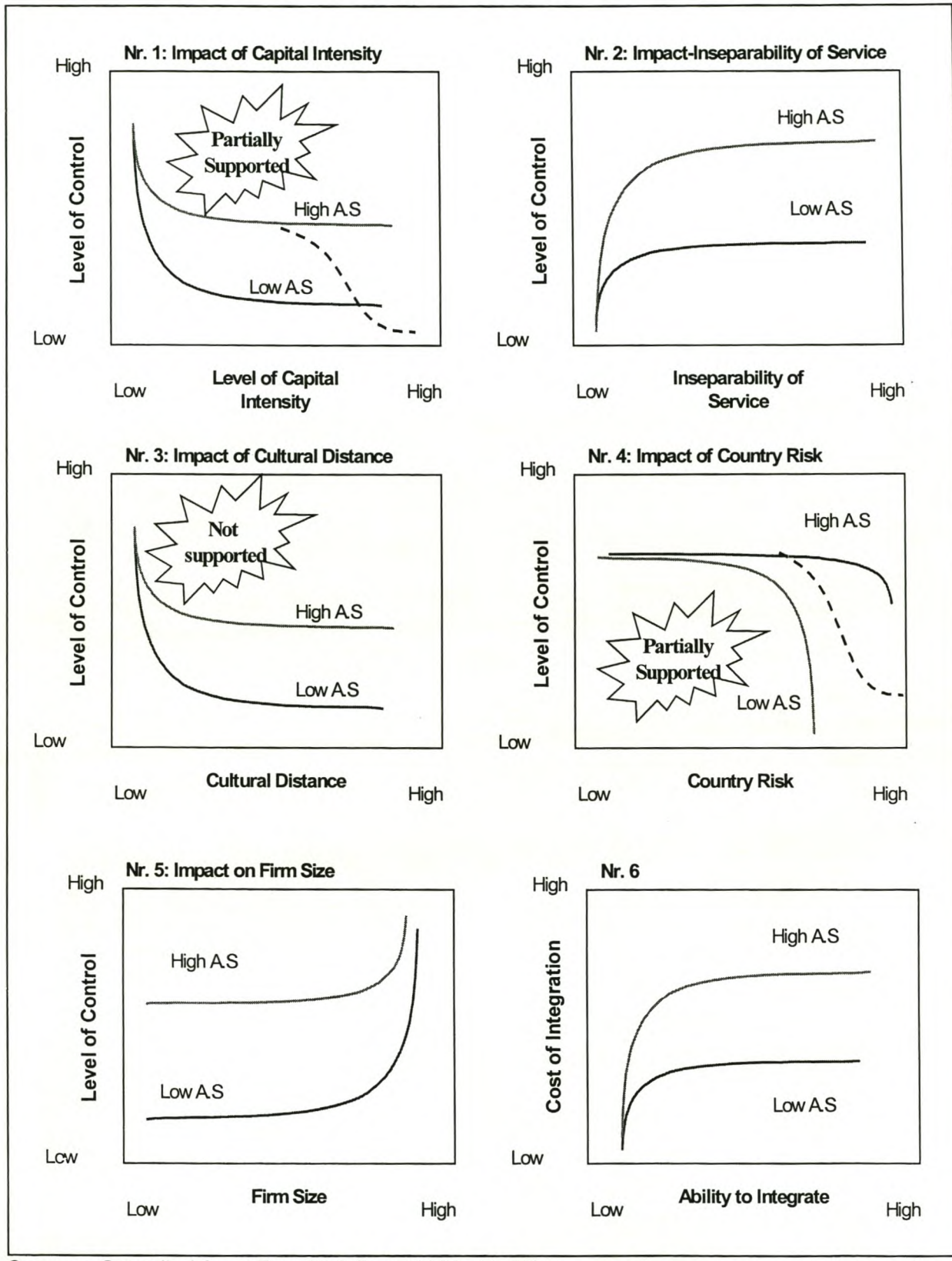
5.9.2.1 Capital Intensity

Figure 45, no. 1 shows that the 'inverse relationship between asset specificity and service firm's utility for share-control modes will become stronger with increasing capital intensity' (1993:24). However, it was only partially supported by the findings. At higher levels, rising capital intensity weakens the relationship. At very high levels of capital intensity, high asset specificity firms are more likely to adopt shared control modes than low asset specificity firms

5.9.2.2 Inseparability

Figure 45, no. 2 denotes that the 'inverse relationship between asset specificity and service firm's utility for share-control modes will be stronger for inseparable services than for separable one' (1993:24). The findings confirmed the hypothesis.

Figure 45: Moderators of the Impact of Asset Specificity in the Service Industry



Source: Compiled from Eramilli & Rao (1993: 19-38)

5.9.2.3 Cultural Distance

The study did not support Figure 45, no. 3 that the 'inverse relationship between asset specificity and service firm's utility for share-control modes will become stronger with increasing cultural distance between the home and host countries' (1993:25). Cultural distance does not raise costs for low asset specific firms in order to divest control. The effect of cultural distance was found significant and positive.

5.9.2.4 Country Risk

Figure 45, no. 4 hypothesises that 'the inverse relationship between asset specificity and service firm's utility for share-control modes will become stronger with increasing country risk' (1993:25). The study only partially supported no. 4, since high asset specificity firms will yield more control in higher risk situations than anticipated.

5.9.2.5 Firm Size

The impact of firm size as illustrated in Figure 45, no. 5 is supported by the findings. 'The inverse relationship between asset specificity and service firm's utility for share-control modes will become weaker with the increasing size of the firm' (1993:25). High asset specificity firms will be virtually untouched by firm size, where low assets specificity firms will increase their level of ownership as the size of the company increases.

Proposition 33: Asset Specificity in Service Firms

All things being equal, service firms will be more likely to favour share-control entry modes when asset specificity is low. The tendency intensifies when services are inseparable, with increased country risk or when a firm becomes smaller.

5.10 Project and Partner Specific Determinants of Entry Mode Choice

5.10.1 Relative Size Subsidiary of Subsidiary

Bell (1996) expected that due to limited resources a MNC would adopt lower ownership levels when entering a foreign market with a relatively big subsidiary. However, it is found that the relative size of investment has a positive correlation with the level of ownership, contrary to expectation. Larger investments significantly increase the probability of WFOE's. Bell (1996) resolves that MNC's might want to avoid the risk of unilateral dependence when a large subsidiary is important to the overall strategy of the company. The only contrasting

study is that of Kogut and Singh (1988b), while Hennart (1991) and Larimo (1993) obtained non-significant findings (see Table 14).

Proposition 34: Relative Size Subsidiary

All things being equal, as the size (importance) of the subsidiary increases relative to the parent, it will be more important adopt a high level of control due to the strategic importance of the subsidiary.

5.10.2 Technical Absorptive Capacity of Transferee

Resource requirements of a technology transfer can be defined as 'its demand upon the transferor's input of resources' (Tsang 1997: 159). The greater the demand for inputs, the greater the required control over the subsidiary. Technical absorptive capacity (TAC) of the transferee refers 'to the ability to assimilate, adapt and integrate the technology into its production system' (1997: 159). Pointing to a number of studies Tsang (1997) suggests that TAC is a function of prior related knowledge and that manufacturing experience, firm size and R&D intensity are determinants of TAC. Consequently 'when the technical absorptive capacity of the transferee is low, firms will prefer transfer modes that require high resource commitments' (1997: 160).

Proposition 35: Technical Absorptive Capacity

All things being equal, when the TAC of the potential partner is low, the firm will be required to obtain higher levels of ownership of the foreign subsidiary.

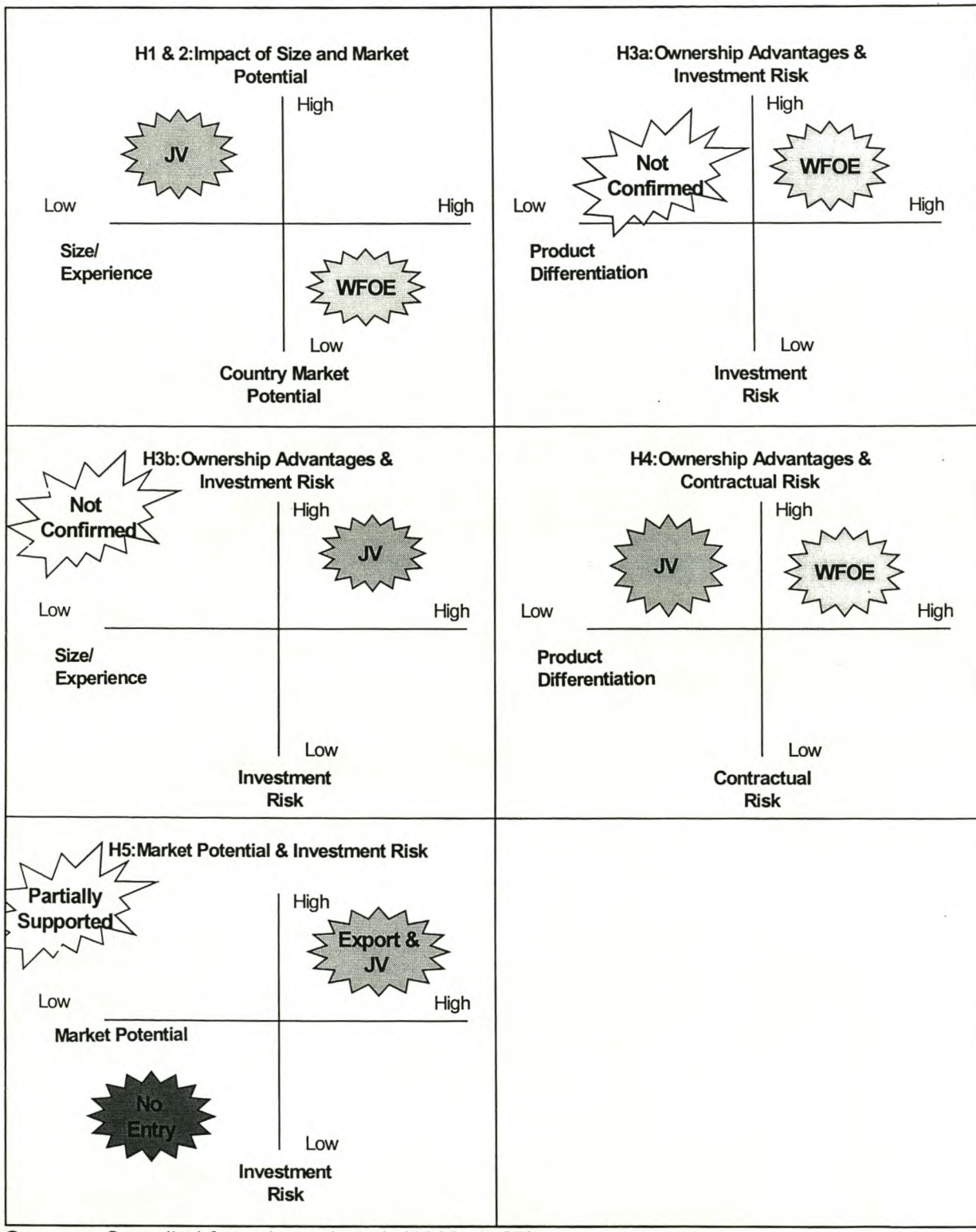
5.11 Interrelations between determinants of Entry Mode Choice

Argwal et al. (1992: 1–27) examined the impact that interrelationships among ownership-, location- and internalisation factors had on firms' choice of foreign market entry modes.

Building on the eclectic framework, Argwal et al. (1992) identified variables within the framework. Firstly within ownership advantages, the ability to develop differentiated products, firm size and international experience. Secondly, location advantages, including marketing potential and investment risk. Thirdly, internalisation risks, of which only contractual risk was identified. The U.S equipment leasing industry (service industry) was

surveyed and analysed it by means of a factor analysis by means of multi-nomiallogistic regression. Figure 46 illustrates the relationships have been studied:

Figure 46: Impact of Ownership, Location and Internalisation Factors on Entry mode



Source: Compiled from Argwal et al. (1992: 1–27)

5.11.1.1 Size/ International Experience and Market Potential

Figure 46, H1 indicates that 'firms that are larger and that have higher multinational experience are more likely to choose a sole venture for entry in relatively lower market potential countries' (1992: 7). In the same token, Figure 46, H2 shows 'firms that are smaller and that have lower multinational experience, are more likely to choose a joint venture for entry in relatively higher market potential countries' (1992: 7. H1 & 2 were confirmed.

5.11.1.2 Ownership Advantage and Investment Risk

Argwal et al. (1992) wrongly hypothesised 'firms that have higher ability to develop differentiated products are more likely to choose a sole venture mode in markets that have higher investment risk'. Moreover, 'firms that are larger and have higher multinational experience may have a lower probability of choosing a sole venture mode in such countries' (1992: 8) (Figure 46, H3b). The study found that firms that have a greater ability to develop differentiated products do not have a significant mode preference under an investment risk situation.

5.11.1.3 Ownership Advantage and Contractual Risk

Confirming Figure 46, H4 the study found 'firms that have a higher ability to develop differentiated products are likely to choose a sole venture mode in countries characterised by high contractual risk. Firms that 'do not have this ability may choose a contractual mode even when the risk are high' (1992: 9). The result emphasises that firms with differentiated products place a premium on maintaining control.

5.11.1.4 Market Potential and Investment Risk

Partially supporting Figure 46, H5 in 'countries characterised by high market potential and high investment risk, firms may show a higher preference for exporting' (1992: 10) and not for joint ventures as was hypothesised.

In summary, small firms with limited international experience prefer to enter high potential markets through shared entry modes. Firms with a higher ability to differentiate products are averse to contractual-risk and prefer investment modes (WFOE's). While investment-risk deters companies away from investment, for strategic considerations, bigger companies continue to invest.

5.12 Relative Importance of Determinants of Entry Mode Choice

One area lacking in the entry mode research is the relative importance or weight of each determinant or group of determinants. Delios & Beamish (1999: 915-933) did however empirically investigate the relative importance of transactional, institutional and experience influences on the ownership strategies of Japanese investors in East and Southeast Asia. The transactional variables embody contributed assets (asset specificity) and complementary assets. Table 16 highlights the hypothesis and results of the study.

Table 16: Transactional, Institutional, and Experience Influences on Ownership Structure

Variable (Delios & Beamish 1999)	Definition	HP	Expected Relation to Ownership	
Contributed Assets			HP	Act
▪ Advertising Intensity	Advertising expenses/sales	H1	+	+
R&D Intensity	R&D expenses/sales	H1	+	+
Complementary Assets				
Resource Industry	Entry into resource-based industry	H2	-	-
Relatedness	Investment made in parents main line of business	H2	-	Ns
Relative Size	Affiliate employment/parent employment	H2		+
Institutional Environment				
Host Country Risk	Extent of political and economic risk	H3a	-	Ns
Host Country Restrictiveness	Extent of restriction on foreign ownership	H3b	-	-
Intellectual Property Protection	Extent of intellectual property protection	H3c	-	-
International Experience				
Export Intensity	Export Revenue/ Sales		+	+
Number of Foreign Investments	Total number of Japanese parents foreign investments		+	-Ns
Years of Host Country Experience	Number of years of operation experience in the host country		+	+
Dependant				
Equity Ownership	Percentage ownership by affiliated Japanese firms			

Source: Compiled from Delios & Beamish (1999: 915-933)

Delios & Beamish (1999: 930) found that experience and institutional factors are the most important determinants of ownership strategy. Institutional variables affects ownership structure at both regulatory and risk levels. Transactional factors are less important than experience and institution factors. Firms operating in technologically and marketing intensive

industries tended to take higher ownership positions when making foreign investment, however the effect is relatively weaker than institutional- and experience related effects. One strong effect of transaction cost factors is the strong positive relationship between proprietary content of firm's assets and the level of ownership.

5.13 The Choice between Minority-, 50/50-, or Majority Joint Ventures

Bell (1996) submits that minority-, 50/50- and majority JV's are three distinct forms of organisation. Each form has unique characteristics and features. A global strategy will significantly increase the likelihood of a majority owned JV over a WFOE. Majority owned and 50/50 JV's are used to enter rapidly growing industries. International experience will influence MNC's to prefer WFOE's to majority JV and majority JV's to all types of JV's. The 50/50 JV's are preferred when the partner is highly experienced in the host country. Product experience and asset specificity did not show any significant effect on the choice between the level of JV's. Brand name companies prefer WFOE's to all types of JV's, especially 50/50- and minority JV's. The curvilinear effect of cultural distance holds for all three types of JV's. That is for culturally similar and distant cultures JV's will be preferred to WFOE's. Host country risk impels companies to opt for 50/50- and majority JV's. The analysis does not support the perception that companies will opt for a minority share in high-risk situation. Restrictive policies' effect on the preference for WFOE's to 50/50 JV's is significantly. MNC's prefer 50/50- and majority JV's in developing countries.

Bell (1996: 129) summarises his findings: 'JV's are more likely to be established when a high-growth industry is entered; the investing firms has much host country experience; the cultural differences between the home and the host country are either very small or very large; a risky host country is entered, and when the host country has a high level of welfare.

WFOE's are more likely to be established when the level of competition in the industry entered is high; the investing firm has much international experience; the size of the foreign subsidiary is relatively large; the assets transferred to the foreign affiliate are highly specific and the investing firm has a good reputation.

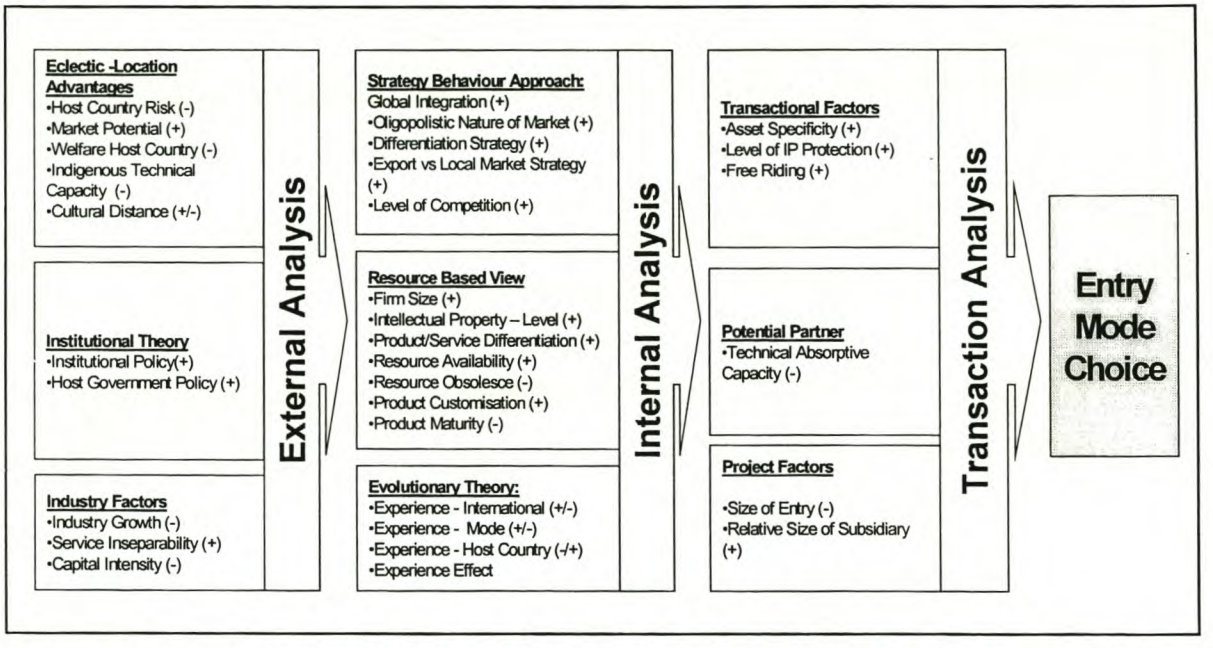
Three variables appeared to have no significant effect on the choice between a JV and WOS: Investing firm's strategy, its experience with products and the policy of the host government.

5.14 Summary

Upon gaining a understanding of the theoretical perspectives underlying entry mode choice this chapter aimed to identify entry mode determinants as it relates to each theoretical perspective. Current entry mode models do not provide an adequate framework for guiding entry mode choice, since the models are too narrowly focussed on a single or a few theoretical departure points. The model proposed integrates the dominant theories with its relevant entry mode determinants into a logical framework that can guide a foreign entrant to choose the most appropriate ownership level. In addition, the impact of each determinant on the ownership level in a foreign invested enterprise was assessed.

Figure 47 summarise the proposed positive or negative relationship with ownership level with a (+) or (-).

Figure 47: A General Market Entry Mode Decision Framework



Sources: Bell (1996), Tsang (1997), Anderson & Gatignon (1986), Delios & Beamish (1999)

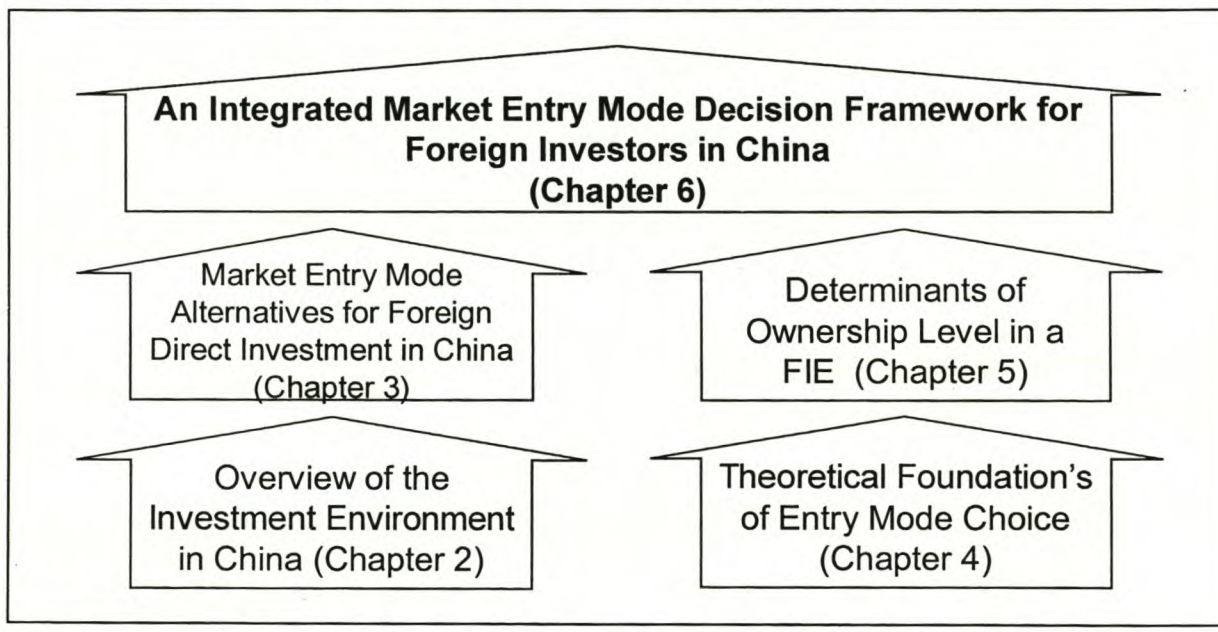
Finally it is suggested although one study found institutional and experience variable to be more influential than transaction cost variables, that the relative strength of the determinants need to be further studied.

6 An Integrated Market Entry Mode Decision Framework for Foreign Investors in China

6.1 Introduction

Chapter 6 provides the final building block for advancing a market entry mode decision framework for China (see Figure 48). In the first pillar, chapters 2 and 3 described the general investment environment of China, and critically reviewed China-specific entry modes available for the foreign direct investor. Each investment vehicle represents a different level of resource commitment, control or ownership.

Figure 48: Market Entry Mode Decision Building Block Five



The second pillar, chapters 3 and 4, reviewed the theoretical foundations for entry mode choice in order to draw from the theoretical foundations the general determinants of entry mode choice. Entry mode determinants as researched have been reviewed and integrated into a general market entry mode decision framework. Chapter 6 then, will need to integrate the general entry mode framework with the China-specific environment.

To convert the general entry mode framework to a China-specific framework, two steps need to be taken. Firstly, the China-specific entry mode literature must be reviewed in order to identify any additional China-specific determinants of entry mode choice. Secondly, the

framework must be applied to both China as a host country and South Africa as a home country to be able to make proposition specifically for the Chinese situation.

6.2 Review of Entry Mode Research Applied to China

Only a few studies exist that apply entry mode determinants to the Chinese context or identified China unique determinants. Firstly, Pan (1996) examined the determinants of foreign equity ownership in joint ventures in China. Secondly, Pan & Tse (1997) proposed a model for entry mode choice and formation of alliance in China. Thirdly, Cui (1997) proposed an evolutionary approach to entry mode choice, while Sun (1999) studied the impacts of intellectual property protection, host country risk and social distance in the Chinese context.

6.2.1 Pan's Determinants of Ownership Level in EJV in China

Drawing on the eclectic framework and the bargaining power literature, Pan (1996: 1-28) examined the determinants of foreign equity ownership in EJV in China (see Table 17). In addition to the general, Pan offers new variables of ownership level in China including the level of state ownership of the Chinese partners, the alignment of local vs. foreign partners in an EJV, the choice of EJV location in China and EJV contractual duration. The determinants are categorised by ownership preferences (the level of ownership the foreign partner wants) and ownership concessions (the level of ownership that the partner can get). Ownership concessions are the outcome of the bargaining process with the host country partner or government institution.

Pan (1996) identifies which of the determinants will have a significant influence on the preference of a particular EJV type over another (see Table 18). Country risk of China, foreign partner alignment, EJV duration and EJV investment amount will determine whether a partner prefers equal equity ownership instead of a minority ownership. Whether a firm prefers a majority ownership level instead of a minority ownership level, will be determined by capital input, EJV investment amount, foreign partner alignment, advertising intensity and competitive intensity. Country risk of China, foreign partner alignment and competitive intensity will determine whether a 50% ownership will be preferred over a majority ownership.

Table 17: Influences on Foreign Equity Ownership Level in Joint Ventures in China

Variable	Description of Hypothesis	HP	Relationship	
Ownership Preferences			**HP**	**Act**
Advertising Intensity	The foreign partner is **more** likely to own a 50% or a majority share as the level of industry advertising intensity increases	H1	+	+
Country Risk of China	The foreign partner is **less** likely to own a 50% or a majority share as the level of risk in the host country increases	H3	-	-Ps
Foreign Capital Input	The foreign partner is **more** likely to own a 50% or a majority share as its capital contribution increases	H2	+	+
EJV Investment Amount	The foreign partner is **less** likely to own a 50% or a majority share as the total EJV investment amount increases	H4	-	-
EJV Contractual Duration	The foreign partner is **more** likely to own a 50% or a majority share as the contractual duration increases	H5	+	+
Cultural Distance	The foreign partner is **less** likely to own a 50% or a majority share as the cultural distance between the source country and the host country increases	H6	-	+
Competitive Intensity	The foreign partner is **less** likely to own a 50% or a majority share as the level of industry competitive intensity increases	H7	-	+
Ownership Concessions			**HP**	**Act**
Local Partner State Ownership	The foreign partner is **less** likely to own a 50% or a majority share when the local partner is owned by central of provincial- level state entities	H8	-	Nc
Local and Foreign Partner Alignment	The foreign partner is **more** likely to own a 50% or a majority share as the number of foreign partners involved in the venture increases. Similar effect should hold true for the local partners in the venture.	H9	+	+
Location	The foreign partner is **more** likely to own a 50% or a majority share when the EJV is located in South China or one of the three autonomous cities of Beijing, Shanghai and Tianjin.	H10	+	+

Source: Compiled from Pan (1996: 1-28)

Table 18: Significant determinants for EJV Type

▪ 50% Ownership vs. Minority Ownership	▪ Majority Ownership vs. Minority Ownership	▪ 50% Ownership vs. Majority Ownership
• Country risk of China • Foreign partner alignment • EJV duration and • EJV investment amount	• Capital input • EJV investment amount • Foreign partner alignment • Advertising intensity • Competitive intensity	• Country risk of China • Foreign partner alignment • Competitive intensity

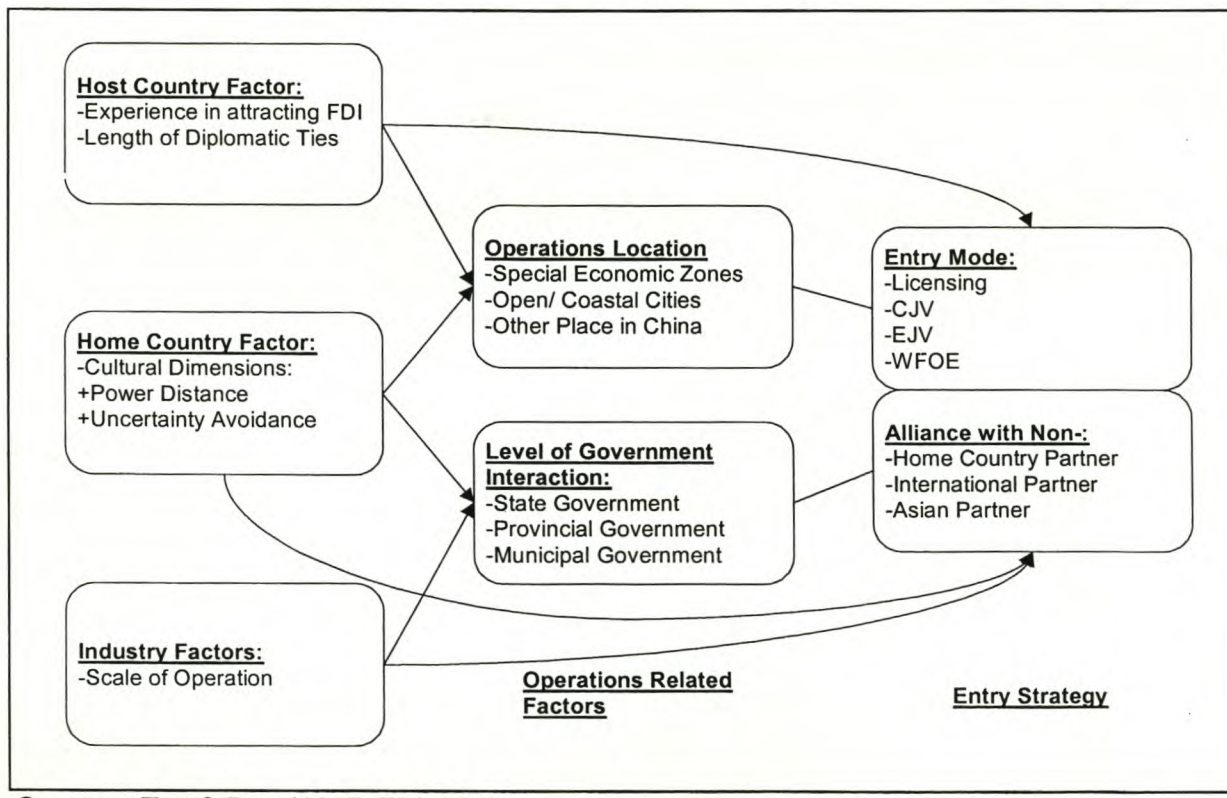
Source: Compiled from Pan (1996: 1-28)

6.2.2 Tse & Pan's Model of Entry Mode Selection and Alliance Formation

Tse & Pan (1997: 779-806) examined two dimensions of foreign market entry strategy, namely mode of entry and formation of alliances. They suggest that formation of alliances as entry strategy have not been studied adequately. Drawing on the transaction cost approach of Anderson and Gatignon (1986) and eclectic framework, they propound that firms form alliances to reduce risk, share technology, improve efficiency, enhance global mobility and strengthen global competitiveness. In addition, firms form alliances to share risk, pool resources, protect assets and to develop an ability to react quickly (Pan & Tse: 1996).

In Figure 49, Tse & Pan (1997) offer a conceptual model for entry mode selection and formation of alliances in China. The model incorporates home country-, host country- and industry factors. In addition, the model suggests operation location factors, as well as the level of government negotiation factors. Seven sets of hypothesis are proposed and tested utilising a longitudinal sample of 2998 foreign business activities in China for the period between 1979 - 1993. The business activities include firms from the U.S, Europe, Japan and other Asian Countries.

Figure 49: Model of Entry Mode Selection and Alliance Formation in the PRC



Source: Tse & Pan (1997: 779-806)

Table 19 describes the hypothesis and findings of the study. The findings will be discussed where required in the subsequent sections.

6.2.3 Cui's Evolutionary Approach to Market Entry in China

Cui (1997: 87-111) analyses MNC entry and expansion in China and proposes four stages of development: entry preparation, market entry, market expansion, and experienced entrant.

Cui (1997) suggests that a deterministic approach to market entry selection is not conclusive. Rather an evolutionary approach provides a more holistic view of market entry. Market development and convergence of MNC's in China offers an opportunity to test the evolutionary approach. Cui (1997) criticises previous research for just focusing on specific decisions rather than looking at internationalisation as a process of development from an international-, to multi-national- to a global operation. Globalisation of a firm is a gradual process of learning, reaction and adaptation. A firm's success and survival are tied to ability to continuously learn and adapt in a changing environment.

Table 20 presents the stages of global market expansion in China. In the preparation stage firms prepare to enter the Chinese market. The key concern during the preparation stage will be to perform market research and assess the market demand, political risk and potential feasibility of the operation. The relatively low risk, low cost representative office offers the flexibility to perform research activities and to prepare the ground for later entry.

Table 19: Model of Entry Mode Selection and Alliance Formation for China – Hypothesis and Findings

Variable	Definition	HP	Relationship	
			HP	Act
Host Country Factor	**China's Experience with Attracting FDI (Increase in experience)**		+	
	Adopt a more equity-based entry mode	H1a	+	+
With Own Country	Be more likely to form alliance with non-PRC Firms when entering China	H1b	+	+
	Locate in other parts of China	H1c		NC
	Interact with municipal governments (less reliant on state government	H1d		Ns
Host Country Factor	**Length of Diplomatic Ties (Longer Diplomatic Ties)**		+	
	Adopt a more equity-based entry mode	H2a	+	+
	Be **less** likely to form alliance with non-PRC Firms when entering China	H2b	-	Nc
	Locate in other parts of China	H2c	+	+
	Interact with municipal governments (less reliant on state government	H2d	-	Nc
Host Country Factor	**High Power Distance Cultures**		+	
	Adopt a more equity-based entry mode	H3a	+	+
	Be **less** likely to form alliance with non-PRC Firms when entering China	H3b	-	Ns
	Locate in other parts of China	H3c	+	+
	Interact with municipal governments (less reliant on state government	H3d	-	-
Host Country Factor	**High Uncertainty Avoidance**		+	
	Choose a **less** equity-based entry mode	H4a	-	Nc
	Be **more** likely to form alliance with non-PRC Firms when entering China	H4b	+	Nc
	Locate in SEZ or Open Cities	H4c	-	-
	Interact with higher level Chines e governments	H4d	+	+
Industry Factor	**Large Scale of Operation**		+	
	Adopt a **more** equity-based entry mode	H5a	+	+
	Be **more** likely to form alliance with non-PRC Firms when entering China	H5b	-	Nc
	Locate in SEZ or Open Cities	H5c	+	Nc
	Interact with municipal governments (less reliant on state government	H5d	-	-
Operations	**Operation Location (firms in SEZs would):**		+	
	Adopt a **more** equity-based entry mode	H6a	+	+
	Be likely to form alliance with non-PRC Firms when entering China	H6b	-	-
Operations	**Level of Chinese Government (Dealing on lower level of Government)**		-	
	Adopt a **more** equity-based entry mode	H7a	+	+
	Be less likely to form alliance with non-PRC Firms when entering China	H7b	-	-

Source: Compiled from Tse & Pan (1997: 779-800)

Table 20: Stages of Global Market Expansion and Business Strategy Implications

Entry Stage	Key Concerns	Mode and Scale
Preparation	• Market research • Assessment of demand, political risk and financial feasibility	• Middlemen Service • Offshore office • Representative office with small staff
Entry	• Establish beachhead operation • Transfer of capital and management • Smooth transition	• Single local market • Representative Office • The first Joint Venture
Expansion	• Sales growth • Market share • New product development • Product distribution	• Expand to other regional markets • Establish national headquarters • Increase local partners
Experienced	• Customer loyalty • Competition • Co-ordination • Rationalisation	• Expand to marginal markets • Wholly owned subsidiaries • Mergers and acquisitions

Source: Cui (1997: 87-111)

During the entry stages firms will test the market by entering into a single local market. The representative office will be maintained to continue with liaison and research activities. A firm with little international experience will enter into a joint venture to access local market knowledge.

Upon gaining valuable market knowledge and experience, the entrant will enter the expansion stage. More local markets will be entered, while utilising more local partners. The representative offices might be extended to serve as the national head office.

After operating for a number of years in China, foreign entrants become experienced role players. Experienced firms are more concerned with establishing a competitive position, co-ordinating and rationalising various operations. Experienced firms, who find less reason to work in local partnerships since adequate local knowledge has been accumulated, will utilise WFOE's for subsequent entries. Experienced firms will also buy out partners or make acquisitions.

6.3 China-Specific Entry Mode Determinants

Figure 50 offers host country-, home country-, partner related- and project related entry mode determinants that are China-specific. This section will review each of the determinants and make propositions regarding its impact on ownership level in foreign invested enterprises in China.

6.4 Host Country Determinants of Entry Mode Choice in China

6.4.1 Market Potential/ Welfare

The review of the Chinese investment environment in chapter 2 implies that general market potential in China can be regarded as high. Simply appreciating the potential consumer market of 1.2 billion people, a GDP of 8,203 billion yuan (+/- 1000 billion USD) and an annual growth of over the 7 %, no doubt exists that China is potentially the world's biggest consumer market (MOFTEC: 1999). The very high levels of FDI flowing to China since the early 1990 confirm this notion. As a result foreign investors prefer higher levels of ownership when entering China.

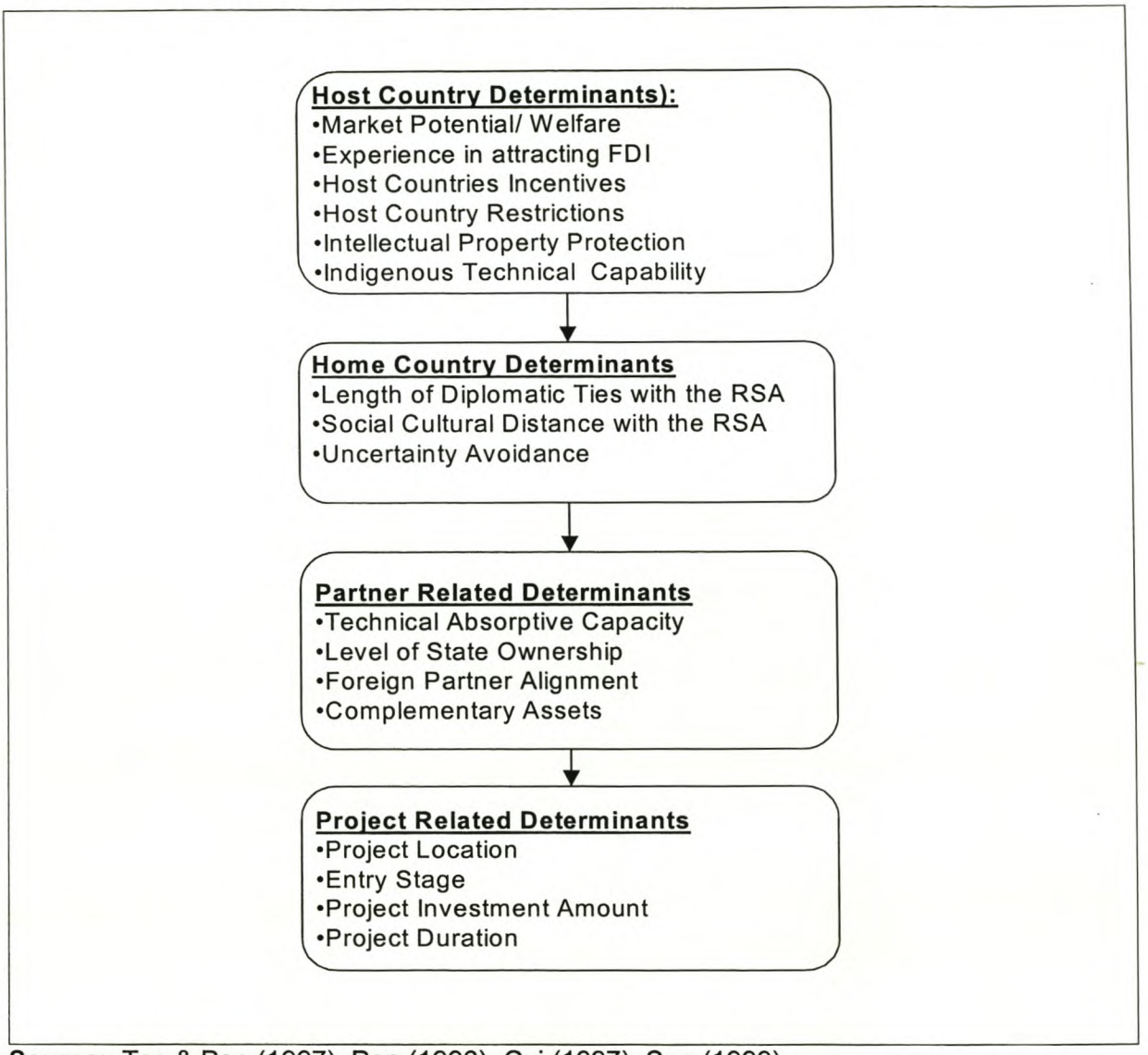
Proposition 36: Market Potential in China

All things being equal, the relatively high market potential in China will result in foreign investors taking higher ownership levels in FIE's than in countries with a lower market potential.

6.4.2 Host Country Risk

Although the host country risk of China in the early 1980's had been high, the risk of doing business in China decreased steadily over the years. One set back was the Tianianmen Square massacre in 1989. Although the political situation since the incident has been relatively stable, it would be a mistake to assume political stability in the long run. China remains a one party Communist State. The example of the former Russia has shown the fall of the ruling party is always possible. For fear of losing its status quo as ruling party, the Communist Party of China encourages the market reforms and economic growth (Dernberger: 1999). The political situation seems to be at least in the medium term to be very stable and can therefore be rated as low to medium.

Figure 50: China-Specific Entry Mode Determinants



Source: Tse & Pan (1997), Pan (1996), Cui (1997), Sun (1999)

Pan (1996) found that a foreign partner is less likely to own high levels of equity, as the level of risk in the host country increases. However the findings suggest that a favourable risk situation does not bring a foreign partner to seek a majority share.

Proposition 37: Host Country Risk of China

All things being equal, the relatively medium levels of country risk in China will not result in significantly higher ownership levels in FIE's in China.

6.4.3 China's Experience in Attracting FDI

Chapter 2 describes the development of China's policies in attracting foreign direct investment in China since 1979. China is the largest recipient of FDI among developing countries and the fourth largest recipient of all countries (Gelb: 2000). In gaining experience with attracting foreign investment, China learned how to create a stable investment environment with incentives for foreign investors. A number of laws and regulations were promulgated to reduce uncertainty for the investor (See Chapter 2 & 3). Tse & Pan (1997) found that increased experience with foreign investment would lead to higher equity investments.

Proposition 38: Host Country Risk of China

All things being equal, China's relatively high level of experience in attracting FDI will result in higher ownership levels in FIE's in China.

6.4.4 Host Government Restrictions

The Chinese government has followed a phased approach in opening up the economy to the outside world (Chapter 2). Both high levels of restrictions and incentives were employed to direct FDI where the government deemed necessary. Restrictions imposed on foreign investors were on three levels: the geographical location of investment, the sectors of investment and lastly, the equity level of investment. Since the government was primarily motivated to upgrade the technology base of its state enterprises, it restricted investment in the initial phases to joint ventures and to the SEZ. In return for the restrictions, foreign investors were granted special privileges such as big tax break.

An interesting policy change currently in China is the drive to eliminate the regional inequalities. Incentives in the previously designated investment areas are being recalled. This while government offers incentives for investing in the undeveloped west. In June 2000 MOFTEC issued a circular containing a list of preferred projects in the undeveloped central and western areas of China (CIFIT: 2000). Table 21 serves as an example of projects that will receive preferential treatment in the under-developed areas in China.

Table 21: A Example of the List of Project in China's Central and Western Regions with Preferential Policies for Foreign Investors

Shanxi Province
1. Storage, freshness keeping and processing of grains, vegetables, fruits and poultry and livestock products
2. Forestation and introduction of good species of trees and plants.
3. Production of phosphorus-free detergent.
4. Technical reforms in cotton textile productions, printing and dyeing enterprises.
5. Manufacturing of new types of textile machines.
6. Construction and management of highways, independent bridges and tunnels.
7. Applied technique development in coal processing and production of coal products.
8. Deep processing of coal tar.
9. Exploration, development and usage of coal bed gas resources.
10. Construction and management of thermal power station with single generator capacity or 300 000 kilowatt and above
11. Exploration and exploitation of copper resources **(not for sole-foreign funded)**
12. Development and manufacturing of high quality of neodymium, iron and boron material and rare-earth mothers.

Source: CIFIT (2000)

Incentives include company tax exemption, exemption from tariff- and other import value added taxes. However in the midst of granting incentives, restrictions apply to ownership levels where the pillar industries are concerned (CIFIT: 2000).

Proposition 39: Host Country Restrictions

All things being equal, China's relatively high level of restrictions in especially the pillar industries will result in lower ownership levels in FIE's.

Proposition 40: Host Country Incentives

All things being equal, the high level of incentives in China's under-developed western areas and 'encouraged' industries will result in higher ownership levels in FIE's.

6.4.5 Intellectual Property Protection

One of the biggest areas of concern for foreign investors over the past few years was, and still is, the status of intellectual property rights (IRP) protection in China. Simone (2000: 12) states that 'billions of dollars worth of counterfeit products are made in China every year,

from cosmetics, food, drugs, pesticides, and electrical appliances to more publicised software, music and films'. In the software and film (VCD's) markets pirate copies constitute 80-100% of respective markets (Weldon & Vanhonacker: 1999).

Clark (2000) gives insight into the birth of the problem. In the mid-1980's virtually no counterfeits existed in China. However since the early 1990's, the production, export and domestic sale of counterfeit products increased dramatically. This trend can be attributed to the following factors: Firstly, the liberalisation of the Chinese market. Previously government controlled factories suddenly had the choice of what to manufacture and more freedom to distribute their goods. Secondly, the establishment of Hong Kong and Taiwan counterfeit producers in China. Thirdly, an increase in appreciation of brand-name products provided incentives for counterfeit producers to profit from the trend. Lastly, due to cost cutting strategies, foreign investors used simplified production techniques, which resulted in products being copied more easily.

Since the early nineties, international trade partners demurred against the lack of legislation to protect them against IPR abuses. Goldberg & Fedder (1991) criticised the new Chinese copyright law and its implementing regulations of June 1, 1991, which violated the Bern Convention for Protection of Literary and Artistic Works and the Universal Copyright Convention on several accounts. Criticism included that insufficient terms of protection were awarded, inadequate enforcement provisions provided and overboard exceptions from protection allowed. For example, users were allowed to make unspecified small amounts of copies for educational or government use, which resulted in government institutions and universities compiling their own libraries of pirated software.

Fortunately, due to international pressure, China has agreed to a number of international treaties on IPR. Their bid to joint the WTO will require China to conform to the Agreement on Trade Related Aspects of Intellectual Property (TRIPS). TRIPS will demand China to enforce copyright, trademarks, patents, and trade secrets within a year of ascension to the WTO (Clark: 2000).

In view of TRIPS, China is currently reviewing the legal framework for intellectual property protection. Nevertheless Clark (2000) cautions that the main problem of implementing the TRIPS will not be the lack of a legal framework, since China's law is already essentially compliant, but rather the weakness of its enforcement regime. Potter & Oksenber (1999) assert that significant reforms in terms IPR have been made. Raids against pirate factories have been done, IPR violators have been fined and some even imprisoned. Nevertheless

problems of administration and enforcement exists. Firstly, despite the formation of an inter-agency IPR administrative conference, which is presumed to co-ordinate IPR centrally, administrative IPR bodies are still scattered and divided. These bodies include the Trademark Office, the China Patent Office, the National Copyright Administration, the State Intellectual Property Office, the Cultural Market Administration and the General Administration of Customers. Secondly, even though the criminal apparatus such as the Public Security Bureau increased, it is still inadequate.

Concerning the inadequacy of the criminal enforcement, Simone (1999) reports that China's record of convicting and jailing counterfeiters has been woeful and only a handful of serious offences resulted in convictions. With regards to 15'000 trademark offences in 1997, only 57 were handed over to the judicial authorities to be investigated. Inadequate fines are another problem. A maximum fine of 50% of illegal revenues (which is almost impossible to determine) is not nearly enough to deter offenders. Protectionism and corruption within the enforcement bodies exist. Typical examples are the tip-offs to offenders before the raids. Potter & Oksenber (1999) add to the list of dilemmas, the lack of resources employed to build a cadre of IPR administration and enforcement.

In summary, China faces a huge IPR protection problem despite reforms. Clark (2000) forewarns that China's entry into the WTO will result in more IPR abuses due to the greater ease that IPR violators can import and export their products. Whenever the economy grows, counterfeits will grow. But 3-5 years after WTO ascension IPR protection can be expected to come under control. As a result, for the medium term, foreign investors will be expected to seek higher ownership level in their new ventures as protection against IPR violators.

Proposition 41: Intellectual Property Protection

All things being equal, weak IPR protection in China will result in higher ownership levels in FIE's in China.

6.5 South African Specific Home Country Determinants

6.5.1 Length of Diplomatic Ties with SA

Tse & Pan (1997) point to the example of Yugoslavia and North Korea who were the first countries to have established diplomatic relations with China in 1949. Their study confirmed that MNC's from countries with longer diplomatic ties will receive more favourable treatment

than those with shorter diplomatic ties, resulting in higher ownership levels in FIE's. A history of diplomatic relationships with China will also influence MNC's to invest in areas outside the SEZ and coastal cities.

South Africa's relationship with the People's Republic of China was strained due to its good relations with the Republic of China (Taiwan) during the apartheid era. The PRC refuses diplomatic relationships with countries that recognise Taiwan's sovereignty as a nation. As a result China was very closed for South African business until the change of government in South Africa (Breytenbach: 1999).

The then vice-president Mbeki recognised the importance of China as potentially the world's biggest market, and in 1998 officially exchanged full diplomatic relations with Taiwan in favour for relations with China (Van der Walt: 1997, 1998). However, in 2000 South Africa's exports to China still lagged behind, with only 1.28% of its total export volume, as opposed to the 2.27% to Taiwan or the 13.68% to the USA (Department of Trade and Industry: 2000). Sun (1998) utilised trade between countries as a substitute for diplomatic relations between two countries, and subsequently it can be derived that the diplomatic relations between South Africa and China are still not favourable, although improving.

In comparison with the US, who exchanged relationships with Taiwan in 1979 (Breytenbach: 1999) for relations with China, South African companies will adopt less equity based entry modes. Illustrating the benefit of longer diplomatic relationships with China, is the signing of the US-China bilateral agreement in November 1999. The agreement will give US companies access to previously restricted industries such as banking, insurance and telecommunication (China Business Review: 2000). In addition, telephone companies will be allowed to hold up to 49% of telecommunication ventures upon WTO entry and up to 50% two years after WTO ascension (International Law Update: 1999).

Proposition 42: Length of Diplomatic Ties with South Africa

All things being equal, the relatively short diplomatic relationship between South Africa and China will result in lower ownership levels in South African FIE's in China as opposed to countries with longer diplomatic ties with China.

6.5.2 Social Cultural Distance

Sun (1999) identified three social cultural groups relating to China:

Group 1: Hong Kong and Taiwan, who share the same language and culture with that of China due to close proximity.

Group 2: Other Asian countries (including Japan, Singapore, Malaysia and South Korea), that share cultural and historical links with China.

Group 3: Western countries (US and Europe) who have very different languages and cultures from that of China.

Analysing annual FDI statistics from MOFTEC, Sun (1999) found that countries from the first two groups have a lower inclination to set up EJV's. The observation suggests that for the Chinese situation an increase in cultural distance between the home and the host country will reduce the level of ownership the foreign entrants will pursue.

Contrary to expectation, Pan (1996) found that an increase in cultural distance increases the likelihood for a foreign entrant to own a 50% or majority share in FIE. Pan's (1996) findings suggest a foreign partner will aim for effective control over operations in higher cultural distance situations. To further complicate the matter Bell (1996) found that both at very low and very high levels of cultural distance that MNC's adopt lower levels of ownership (See discussion in chapter 5).

Literature does not offer any further explanations for the contradictions. However we can speculate that at low levels of cultural distance, firms will utilise both high and low levels of ownership entry modes for different reasons. At medium levels of cultural distance MNC's will prefer higher levels of ownership. High levels of cultural distance will on the one hand increase the frequency of EJV's to learn from local partners, while at the same time firms from high uncertainty avoidance cultures will prefer to maintain a high level of control.

Sun (1999) also found that group 1 & 2 countries employed CJV's more regularly since the uncertainty and lack of legal framework will be more difficult to cope with for a western company. Group 1& 2 companies will also be more likely to set up WFOE's due to a higher level of knowledge of the local culture and language.

South Africa can be viewed as part of group 3 in terms of cultural distance. In other words, the cultural distance between South Africa and China is high. Owing to the large cultural distance, South African companies may react in two possible ways when entering into China.

First, owing the lack of experience, a greater need for control over operations will lead to higher equity levels. Secondly, owing to the lack of knowledge of the local market, South African companies will seek local partners who can provide local market access and knowledge.

Proposition 43: Cultural Distance between South Africa and China

All things being equal, the relatively high cultural distance between South Africa and China will result in lower equity levels in South African FIE's. Instead companies with high levels of uncertainty avoidance, will tend to maintain higher levels of ownership as a measure against the high uncertainty of the distant cultural situation. .

6.6 Partner Related Determinants

6.6.1 Indigenous Technical Capability (ITC) and Technical Absorptive Capacity (TAC)

During the old era of Communism in China, the technical development of the Chinese work force lagged behind. Isolation from the outside world and the lack of experience working on advanced technology created a gap in technological experience and training. As a result the TAC of the older workforce is relatively low, especially those employed in the SOE's.

However since the opening up of China in 1979, the Chinese government pursued the upgrading of technology, and the development of technical and managerial skills of the workforce (Frankenstein: 2000; Chapter 2). Enormous efforts are being made to turn the situation around. In 1999 4.13 million students enrolled as under-graduate students at universities, 3.06 million enrolled in adult higher education and 230 000 enrolled as post-graduate students (an increase of 200 000 to 1998). 10.5 Million students studied at ordinary secondary schools while 14.3 million enrolled in vocational or technical schools. Adult technical training schools offered courses to 101 million people. In addition 2.71 million professional people and technicians were engaged in technical or scientific activities, of which 1.5 million were scientists or engineers. Expenditure on scientific or technical activities was up 10.8 % to 128 billion yuan (USD 15 Billion) (MOFTEC: 1999).

These efforts indicate that a relatively large force of technically trained people is emerging in China. The level of technical knowledge of the upcoming or younger workforce is relatively high, including those from private companies.

Proposition 44: Technical Absorptive Capability

All things being equal, the low levels of TAC among especially SOE workers in China will result in higher ownership levels in FIE's in the medium term, while in the longer term the upgrading of technical skills will relieve the necessity of taking higher ownership by FIE's.

6.6.2 Foreign Partner Alignment

Pan's (1996) proposed and confirmed (rather obviously) that when the number of foreign partners increase in an EJV as opposed to the number of Chinese partners, it is more likely to own a 50% or a majority share in the venture. A similar effect should hold true for the local partners in the venture.

6.6.3 Level of Contractual Risk

In addition to the weak IPR protection in China, a culture of abusing IPR exists (Weldon & Vanhonacker: 1999, Clark: 2000). In section 6.4.5 the problem of intellectual property rights abuses were discussed sufficiently.

Proposition 45: Level of Contractual Risk

All things being equal, the high levels of opportunism of local partners in China will result in foreign partners adopting high ownership levels in FIE's.

6.6.4 Complementary Assets

A local partner should have assets that are valuable to the foreign entrant. As referred to in chapter 3 most foreign entrants lack market knowledge and experience. Their local partners are then expected to provide the necessary market knowledge, experience as well as connections with government, suppliers and customers to be successful. Chapter 3 also pointed out that many partners in China fail on all these accounts.

Proposition 46: Complementary Assets

All things being equal, the relatively low levels of technical- and market knowledge, and market access of Chinese partners will deter foreign investors from entering into joint ventures.

6.7 Project Related Determinants

6.7.1 Level of Intellectual Property of Transferred Technology

Drawing on a number of writers, Sun (1999) states that the proprietary nature of a product is highly correlated with ownership level. A high investment in research and development will lead to higher ownership. However the more mature the product class, the less control firms would demand of a foreign business entity. High-tech propriety products give more bargaining power with the host government.

Applying this to the Chinese situation, Sun (1999) found that a large number of foreign investment projects utilise standard technology while employing a large number of labourers. Such investment projects normally employ an EJV with a local partner. However in the high tech sectors, he found that between the period of 1979-1993 WFOE's accounted for 55.2% of the entries. Thus a high level of technological content will also lead to higher ownership levels in China.

Pan (1996) employs advertising intensity as a proxy for the level of intellectual property of the product. He found that the foreign partner is more likely to own a 50% or a majority share as the level of industry advertising intensity increases.

Proposition 47: Level of Intellectual Property of Transferred Technology

All things being equal, MNC's transferring technology with a high intellectual property content to China will prefer greater ownership in the FIE's, while firms transferring technology with a low level intellectual property or mature technology to China will yield ownership in the FIE's.

6.7.2 Level of Chinese Government Dealings

Tse & Pan (1997) propose that the level on which a foreign firm deals with the government will have an impact on the level of ownership in the venture. Mainly three levels of government in China exist. The state (central -), municipal- and local governments. The nature, size and location of the project will determine the level on which a firm interacts with the government. Each level of government represents a different level of risk for a foreign firm. Higher levels of government have more authority to interpret regulations and approve projects, whereas lower levels of government are more flexible and have fewer regulations to conform to. Pan (1997) found that projects that deal with lower levels of government will adopt higher levels of ownership in the FIE's.

Proposition 48: Level of Chinese Government Dealings

All things being equal, FIE projects dealing with municipal and local government levels will adopt higher ownership levels than those who deal with the central government of China.

6.7.3 Stage of Entry

As discussed in 6.2.3, Cui (1997) offers an evolutionary approach to market entry in China. FIE's enter and expand into China in four stages of development: entry preparation, market entry, market expansion, and experienced entrant. At later stages of market entry, FIE's will adopt higher ownership levels than early stages.

Proposition 49: Stage of Entry

All things being equal, FIE's in later stages of market entry in China will adopt higher ownership levels than those in earlier stages of entry.

6.7.4 Project Location

Pan (1996), Tse & Pan (1997) and Sun (1999) propose project locations as a very important determinant of entry mode choice. Sun (1999) points to the connection between the location determinant and country risk. Special economic zones and coastal cities have attracted the majority of foreign investment and consequently developed the necessary infra-structures and services for a foreign entrant to be successful. Implementing a project successfully in the under-developed western areas involves more uncertainty. Foreign entrants perceive that the circumstances in economic zones involve lower risks and will as a result be more likely to take a higher ownership position in these cities, as opposed to under-developed western areas. Sun's (1999) regression analysis confirmed that in the south-east coastal areas FIE's preferred majority JV's and WFOE's to minority JV's. Sun's (1999) finding is consistent with Pan's (1996) observations that partners locating in the SEZ or coastal cities, will be more likely to own a 50% or majority share when the EJV is located in South China or one of the three autonomous cities of Beijing, Shanghai or Tianjin.

Proposition 50: Project Location

All things being equal, FIE's locating in SEZ's and open coastal cities will take higher ownership positions than those locating in under-developed western areas of China.

6.7.5 Investment Amount and -Duration

From a resource perspective it can be expected that FIE's will not be able to take high ownership positions in very big investment projects. Pan (1996) found that as the total investment in an EJV increases, the less likely the foreign partner would own a 50% or a majority share.

Similarly it can be expected that projects of longer duration, will be more important to a foreign investor. Pan (1996) found that as the investment duration increases, the foreign partner is more likely to own a 50% or a majority share in a FIE.

Proposition 51: Investment Amount

All things being equal, the larger the investment amount required from the foreign investor, the lower equity position will be taken up in a FIE in China.

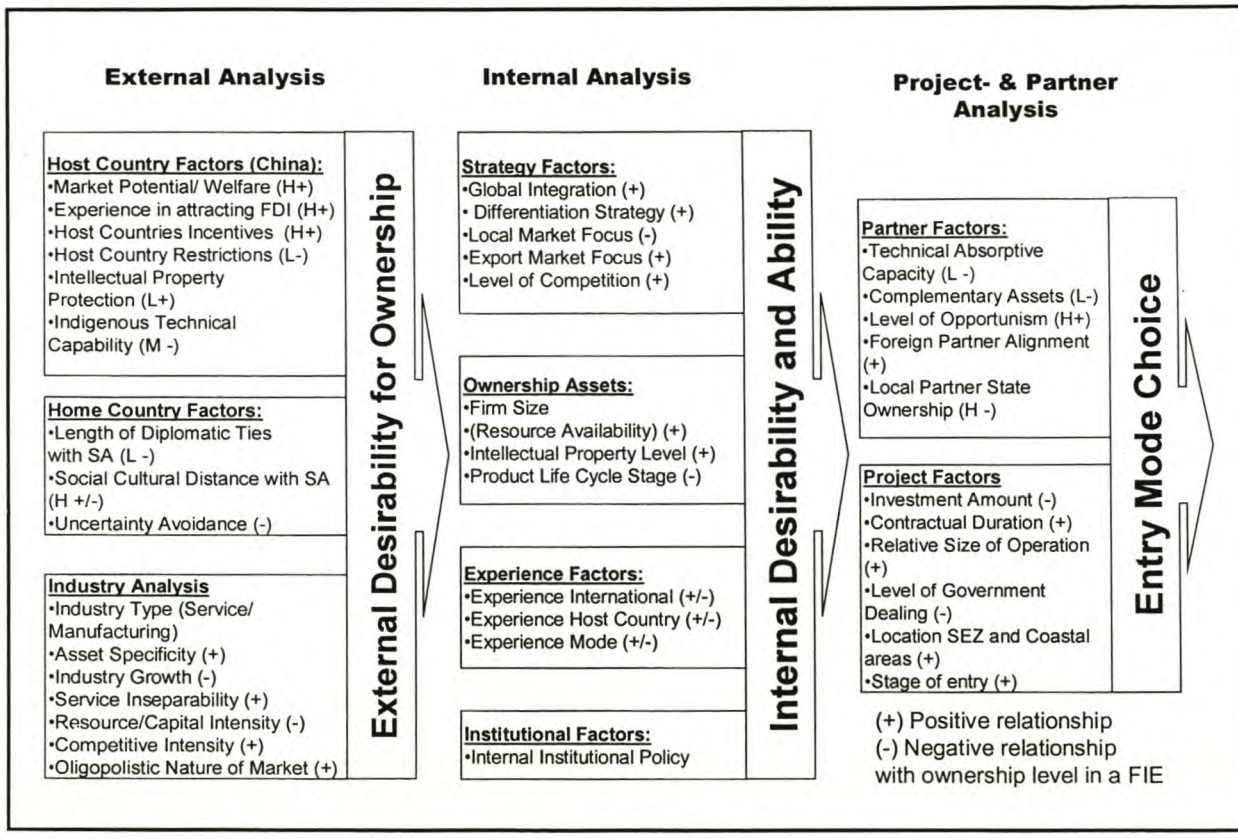
Proposition 52: Investment Duration

All things being equal, the longer the investment duration of the EJV, the larger equity position will be sought by the foreign investor a FIE in China.

6.8 An Integrated Market Entry Mode Decision Framework for Foreign Investors in China

By integrating the general entry mode determinants as discussed in chapter 5 with the China-specific determinants as discussed in 6.3 - 6.7, Figure 49 offers a market entry decision framework for China. The model proposes that a foreign entrant should first consider the external environment's impact on the entry level of ownership. The external environment consists of host country-, home country- and industry determinants. Secondly, the internal environment of the enterprise should be assessed. The internal environment consists of strategic-, ownership assets-, experience- and institutional factors. The outcome of both the external and internal analysis will indicate to the foreign entrant both what the desirability is for a high level of ownership, as well as its ability to enter by means of a WFOE or EJV. Finally, an analysis of the potential partners and the proposed project will determine whether the entrant can in fact enter by means of the desired ownership level. The shaded sections of the model indicate the China-specific variables as discussed.

Figure 51: An Integrated Market Entry Mode Decision Framework for Foreign Investors in China



To further illustrate, a MNC entering China will first review the host country factors. A high market potential, high experience with attracting FDI, host country incentives and weak intellectual property rights protection will provide an incentive to adopt a high ownership level. However a high level of indigenous technical capacity will reduce the need for a high level of ownership, while a specific host country restriction can rule out for instance the possibility of setting up a WFOE.

Depending on the relative strength of the entry mode determinants, a combined impact will be either a low, medium, high or very high ownership preference/ requirement. In the same way the internal determinants will be considered and depending on the relative weight thereof, it can be decided whether it's desirable or required to partner with or not. Should it be desirable or required to partner, each of the partner related determinants should be considered. Project related factors would be the final influence whether to utilise a minority-, 50/50-, majority EJV or a WFOE.

Table 22: Market Entry Mode Scorecard for China

Rating Scale:
1- Lowest Possible Ownership; 2- Minority Ownership;
3- Majority Ownership Desired; 4- Full Ownership

	Determinants	Weight	Point	Score			
External Environment Analysis							
A	**Host Country Factors**	10	29	**29/40 *100=72%**			
1.	Market Potential/ Welfare (H +)			1	2	3	4
2.	Host Country Risk	3	9	1	2	**3**	4
3.	Experience in attracting FDI (H			1	2	3	4
4.	Host Countries Incentives (H +)			1	2	3	4
5.	Host Country Restrictions (H -)			1	2	3	4
6.	Intellectual Property Protection (L +)	4	8	1	**2**	3	4
7.	Indigenous Technical Capability (M-	3	12	1	2	**3**	4
B	**Home Country Factors**	10					
8.	Length of Diplomatic Ties with SA			1	2	3	4
9.	Social Cultural Distance with SA			1	2	3	4
10.	Uncertainty Avoidance			1	2	3	4
C	**Industry Factors**	10					
11.	Industry Type (Service/ Manufacturing)			1	2	3	4
12.	Industry Growth			1	2	3	4
13.	Service Inseparability			1	2	3	4
14.	Resource/Capital Intensity			1	2	3	4
15.	Competitive Intensity			1	2	3	4
16.	Oligopolistic Nature of Market			1	2	3	4
Internal Analysis							
D	**Strategy Factors**	10					
17.	Global Integration vs. Multi-Domestic			1	2	3	4
18.	Differentiation Strategy			1	2	3	4
19.	Local Market Focus			1	2	3	4
20.	Export Market Focus			1	2	3	4
21.	Level of Competition			1	2	3	4
E	**Ownership – Assets**	10					
22.	Firm Size (Resource Availability)			1	2	3	4
23.	Intellectual Property Level			1	2	3	4
24.	Product Life Cycle Stage			1	2	3	4
F	**Experience Factors**	10					
25.	Experience – International			1	2	3	4
26.	Experience – Host Country			1	2	3	4
27.	Experience - Mode			1	2	3	4
G	**Institutional Factors**	10					
28.	Internal Institutional Policy			1	2	3	4

	Determinants	Weight	Point	Score			
H	**Partner Analysis**	**10**					
29.	Technical Absorptive Capacity			1	2	3	4
30.	Complementary Assets			1	2	3	4
31.	Level of Opportunism			1	2	3	4
32.	Local and Foreign Partner Alignment			1	2	3	4
33.	Local Partner State Ownership			1	2	3	4
I	**Project Analysis**	**10**					
34.	Investment Amount			1	2	3	4
35.	Contractual Duration			1	2	3	4
36.	Relative Size of Operation			1	2	3	4
37.	Level of Government Dealing			1	2	3	4
38.	Project Location with SEZ or open city			1	2	3	4
39.	Entry Stage			1	2	3	4
Total of Subtotal							
Weighted Impact on Ownership							

From a practical point of view Table 22 offers a score card for evaluating entry mode choice. A rating scale from 1-4 is used. A score of 1 indicates the lowest ownership desired while 4 points indicate a desire or requirement for full ownership. The foreign entrant should first determine the relative weight of each determinant before it can be scored. The score should be multiplied by the relative weight for the applicable determinant and written in the point's section. Once all the determinants are scored, the total points are calculated and a percentage point calculated against the maximum possible points for the relevant determinants. See the example in scoring in section A of Table 22.

6.9 Summary

Chapter 6 offers the final building block in advancing a market entry mode decision framework for China. Existing entry mode models for China were reviewed and integrated into a holistic market entry mode decision framework for China. The framework suggests a phased approach in analysing the market entry mode decision. Firstly, an external analysis of the host-, home- and industry factors should be performed. Secondly, an internal analysis of the firm strategy, - assets, -policy and –experience should be carried out, while a review of partner and project factors should lastly be performed.

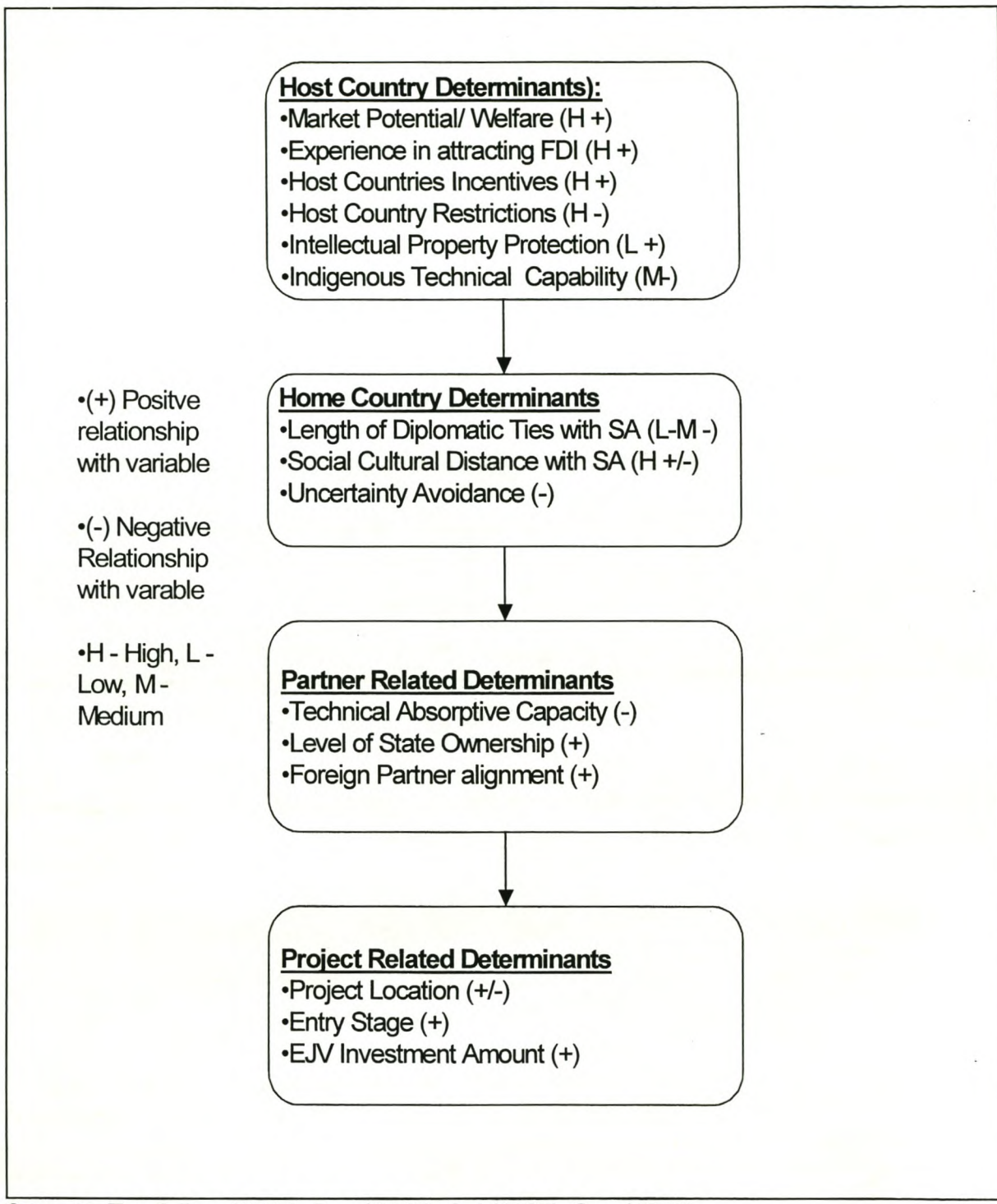
The impact of China-specific determinants in the framework was assessed. Figure 52 summarises the assessment and impact of each China-specific entry mode determinants.

China's relatively high market potential, experience in attracting FDI, and weak intellectual property protection will provide a very high incentive for foreign investors to utilise full control entry modes when entering into China. High levels of opportunism, low levels of technical absorptive capacity and lack of performance from the Chinese partners will intensify foreign investors' desire to take full control over their foreign operations in China. On the other hand, government restrictions in certain sectors will prevent foreign entrants utilising WFOE's or majority EJV's.

MNC's who follow a global strategy, with a relatively high international- and host country experience, who transfer a high level of intellectual property, and have sufficient resources, will be advised to utilise a WFOE entry mode when entering into China.

Lastly, South Africa's relatively short diplomatic relationship and high cultural distance with China, coupled with a lack of host country experience will reduce South African firms' motivation to utilise WFOE's in China. However the weak intellectual property protection and the large potential market potential of China may still persuade South African firms to adopt a WFOE rather than an EJV when entering China.

Figure 52: Summary of the Impact of China-Specific Entry Mode Determinants



Source: Tse & Pan (1997), Pan (1996), Cui (1997), Sun (1999)

7 Summary, Conclusions and Recommendations

7.1 Summary

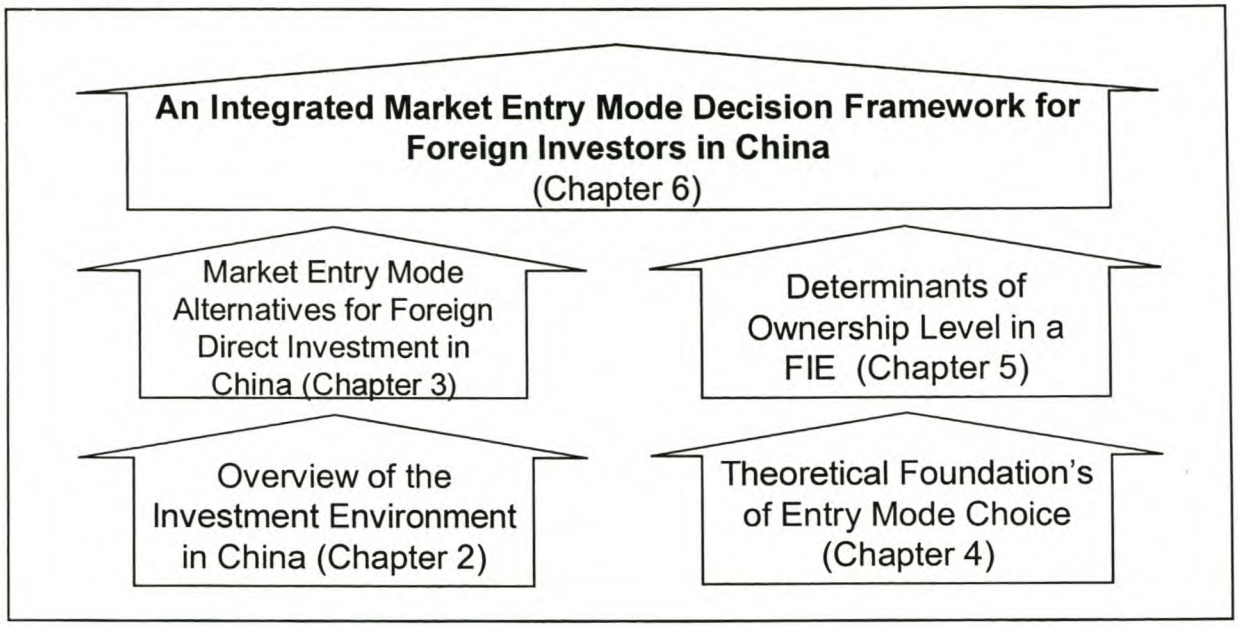
Foreign investment in China over the past 10 years has seen explosive growth. From a meagre US$ 3.8 billion in 1990, FDI in China grew to US$ 45.5 billion in 1999. While its bid to ascend to the WTO has renewed foreign investors' interest China's, problems and frustrations with the CJV's and EJV's have increasingly resulted in foreign investors taking control over its local operations in China through WFOE's.

Entry mode literature is contradictory and fragmented in its approach to offer guidance to the foreign investors in selecting an appropriate foreign market entry mode. This study aimed to advance a market entry mode decision framework for foreign investors in China (MEMDFFIC). In doing so, it critically reviewed current market entry modes available for the foreign investor in China, reviewed and formulated propositions regarding determinants of entry mode choice in general, and integrated China-specific entry mode determinants into a holistic framework of entry mode choice.

The study followed a two-pillar approach as depicted in Figure 53. First a basic literature overview of China's investment environment was performed. In the context of the general investment environment, the entry mode options available for foreign direct investors in China were critically analysed.

The second pillar of the literature overview turned to the theoretical foundations of entry mode choice on which most empirical research was built. From its theoretical departing points the entry mode choice determinants were identified and surveyed. Propositions were offered for each determinant of entry mode choice. The determinants of entry mode choice were then integrated into an entry mode decision framework. Finally, the impact of China-specific entry mode determinants on ownership level in FIE's was assessed and propositions offered.

Figure 53: Method and Structure of the Study



Chapter 2 offered that China's economy and business environment over the past 21 years was characterised by a phased or gradual opening to the outside world. Each phase opened new opportunities for investors, and impacted especially the mode in which foreign entrants do business in China.

Economic- and SOE reforms created opportunities for foreign investors in China: Firstly, continued economic reform broadens the scope for foreign investment possibilities. A wider choice of investment vehicles is available than in the past, especially with the introduction of the JSLC (joint stock limited company). In terms of location, foreign investors are encouraged to invest not only in the SEZ and open coastal cites but also in the under-developed western areas of China. Previously restricted industries, especially in the service sectors are gradually opening to the foreign investor. Secondly, the privatisation of SOE's and especially the dept/equity swap program create opportunities for investors to acquire existing enterprises in part or in full. And thirdly, JSLC also give foreign investors the opportunity to invest more flexibly, by means of the stock exchanges in China.

An analysis of the trends in foreign direct investment confirmed that foreign investors followed an evolutionary approach to entering the Chinese market. Structural changes in the size, location, and sectors of FDI in China were identified. Gaining host country experience increased the average size of investment; investment locations shifted from coastal areas to also include inland areas, while initial investments in lighter industries made room for investment in resource intensive industries. More importantly, host country experience led to

an increased resource commitment in the entry modes utilised. Although EJV's reigned as the preferred entry vehicle, since 1994 the WFOE became a major entry vehicle. By 1999 the WFOE was just as important entry vehicle as the EJV, while the CJV lagged behind in the third place and the JSLC only emerged as a fourth alternative.

Chapter 3 analysed the RO, CJV, EJV and WFOE as market entry vehicles in China. The RO is offered as a low risk, low cost first step entry vehicle. RO's are restricted to market research, liaison and marketing activities in China. It is easy and quick to set up. No restrictions are imposed on which sectors may be entered with a RO. Without first setting a RO, a foreign investor will have difficulty to find partners, suppliers and first customers. The CJV is offered as quick to establish and a quick to terminate entry vehicle. It is ideally suited for shorter-term projects like joint research, -exploration or –property development. A lack of legal framework for the CJV often leaves CJV partners at the mercy of officials' interpretation of the law. CJV's find it difficult to obtain approvals and procure materials due to a perceived lack of commitment to China.

The EJV offers an equity-based investment where the foreign partner is normally required to have an interest of at least 25%. EJV's can be leveraged to gain strategic access to markets, as well to develop knowledge of the local market through the Chinese partner. Partners have valuable contacts with local suppliers, customers and government officials - without which it is difficult to operate successfully. On the other hand disappointing performance, limited contacts, and a high level of opportunism of Chinese EJV partners can harm the success of the venture. WFOE's are established exclusively with foreign funds. It is much easier to establish than the EJV. WFOE's earn all the profit and take full control but also bear the higher costs and carry the full risk. Flexibility and efficiency is easier to attain since no accountability towards the Chinese partner is needed.

Pan & Chi (1999) research found that EJV's perform better in both market share and profitability than WFOE's. They advise foreign investors to take caution for the down side of entering China alone. Valuable advantages of an EJV like favourable government policy, easier procurement of supplies, concessions and market access can be lost when entering alone.

Moreover each entry mode provides the foreign investor with a different level of ownership or control over the operation. Obtaining control over an operation requires more resource commitment and involves more risk. Consequently, the entry mode decision can be redefined in terms of the level of ownership adopted in the FIE.

Chapter 4 propounds foundational theories to deal with the entry mode question. Hymer posits that local firms possess better information about their environment than foreign firms do. For FDI to take place, a foreign firm must have an advantage over the local firm. And the market for the advantage must be imperfect. The TCA evaluate mode choice on the basis of the competitive cost of the alternative governance forms. Cost of contact, contract and monitor must be calculated before the optimal governance form. Transaction cost analysis cautions the entrant to consider the cost involved to adopt various governing structures. Internalisation theory suggests that firms should choose least cost locations and internalise markets to the point where the benefits of internalisation outweigh the cost. The ownership decision should be based on profit maximisation motive.

Dunning (1981, 1988) combines the market imperfection-, the transaction cost and internalisation approaches in an eclectic framework. He offers that the propensity of a firm engaging in international business will be determined by the following factors: First, the extend it possesses (or acquires) assets which the competitors do not possess (ownership advantage). Secondly, its desire to sell or lease these assets to other firms vs. to make use of them internally (internalisation advantage) and thirdly, how profitable it is to exploit these assets in conjunction with indigenous resources of foreign countries, rather than home country (location advantage). Eclectic theory demands a firm to consider which entry mode is most appropriate given the firms' ownership and location advantages.

Porter (1991) tenders that a firm's success depends on the relative attractiveness of an industry and the firms' relative position in the industry. In order to attain such relative position a firm should build a competitive advantage over its competitors. Building a competitive advantage will require a firm to configure its value chain to differentiate it or create a low cost advantage. Underlying the configuration of its value chain, lies the initial conditions and managerial choice. One of these managerial choices is the entry mode choice. In other words, the value chain can be configured through the level of ownership it takes in subsidiaries. The strategic behaviour approach asks what level of ownership is the most appropriate to implement the MNC's strategy and facilitate the development and protection of a sustainable competitive advantage.

Penrose (1959) and Wernerfelt's (1984) resource-based view suggests that a firm should grow through the utilisation of its resources and in the process develop additional assets. Resource position barriers should be erected to distinguish the firms from its competitors. Heterogeneity of assets, limits on competition, imperfect factor mobility and imperfect

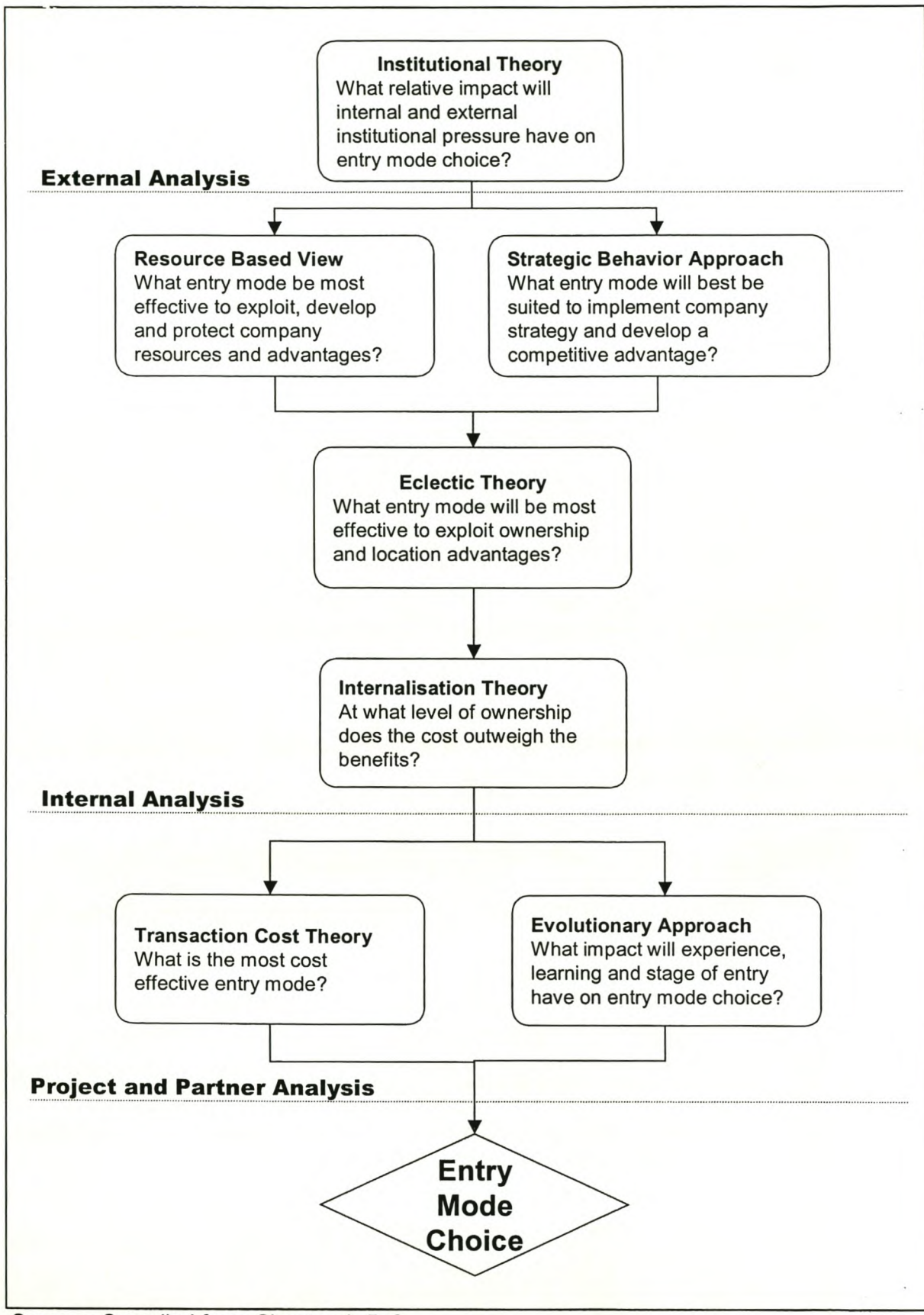
immitabilty are footings for resource position barriers. The resource-based perspective requires foreign entrants to ask the question of how the selected entry mode will impact the exploitation of existing firm resources. Which entry mode will be best suited to the development and protection of firm resources?

External organisations such as the host country government and internal organisations such as the parent firm exert institutional pressure on an entrant. Organisational routines, structures and processes influence subsidiaries to follow similar patterns to the parent. Entrants that experience high levels of isomorphic pressure from the parent will tend to adopt a WFOE. On the other hand, when the government institutional pressure is higher than the internal pressure, firms will adapt to local market conditions.

Figure 54 integrates the foundational theories in a logical framework for analysing entry mode choice. As part of the foreign entrants' external analysis, a firm should consider institutional pressures. The relative impact of external- vs. internal institutional pressures should be assessed. Secondly, an internal analysis of the firm should consider the strategic, resource based-, eclectic- and internalisation perspectives. Thirdly, the project analysis should incorporate transaction cost and evolutionary approaches in selecting the appropriate entry mode level.

Chapter 5 identified entry mode determinants, which delineate each of the theoretical perspectives underlying entry mode choice. Entry mode decision models found in literature do not provide an adequate framework for guiding the foreign investors in selecting appropriate ownership levels. The models are too narrowly focussed on a single or a few theoretical departure points. The general entry mode decision framework proposed integrated all the dominant theories as represented with its entry mode determinants. It can guide a foreign entrant to choose the most appropriate ownership level.

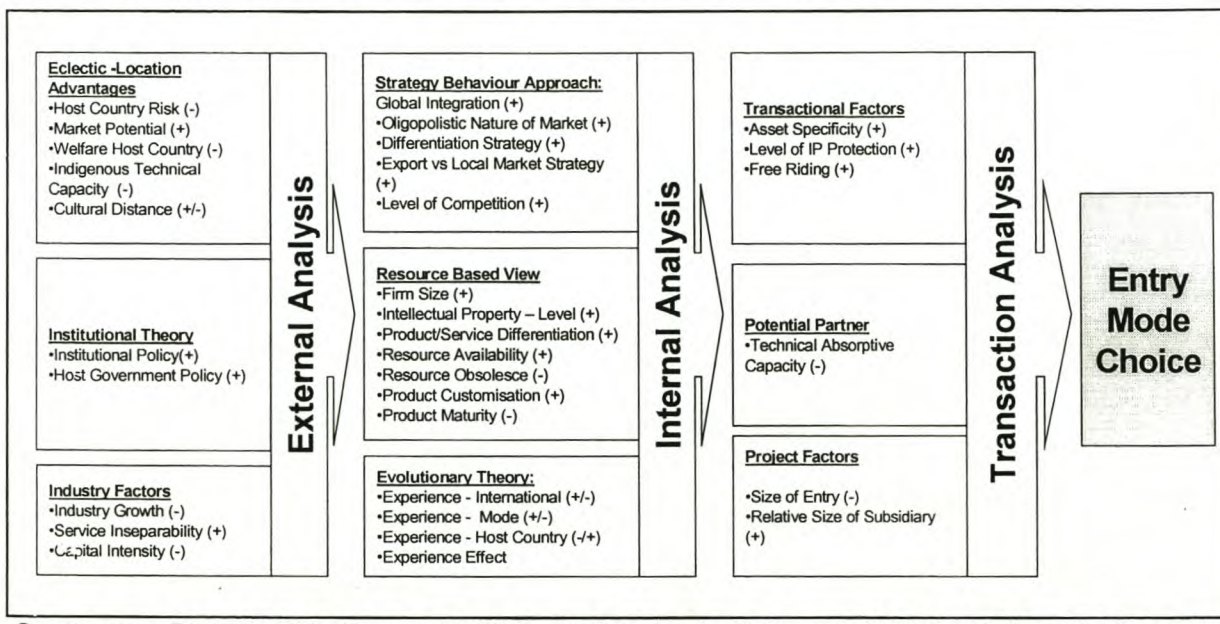
Figure 54: Impact of Foundational Theories on Entry Mode Choice



Source: Compiled from Chapter 4, 5, 6

In addition, each determinant has been assessed in terms of its impact on the ownership level in a foreign invested enterprise. Figure 55 summarises the proposed positive or negative relationship with ownership level with a (+) or (-).

Figure 55: An Integrated Market Entry Mode Decision Framework



Sources: Bell (1996), Tsang (1997), Anderson & Gatignon (1986), Delios & Beamish (1999)

For instance from a strategic perspective, a high level of global integration, differentiation and competition increase the desired level of ownership that an foreign entrant will seek in a FIE. However from a resource perspective if the product is mature, the entrants desire for ownership will be reduced. Depending on the relative strength of each determinant, the entry mode decision can be taken.

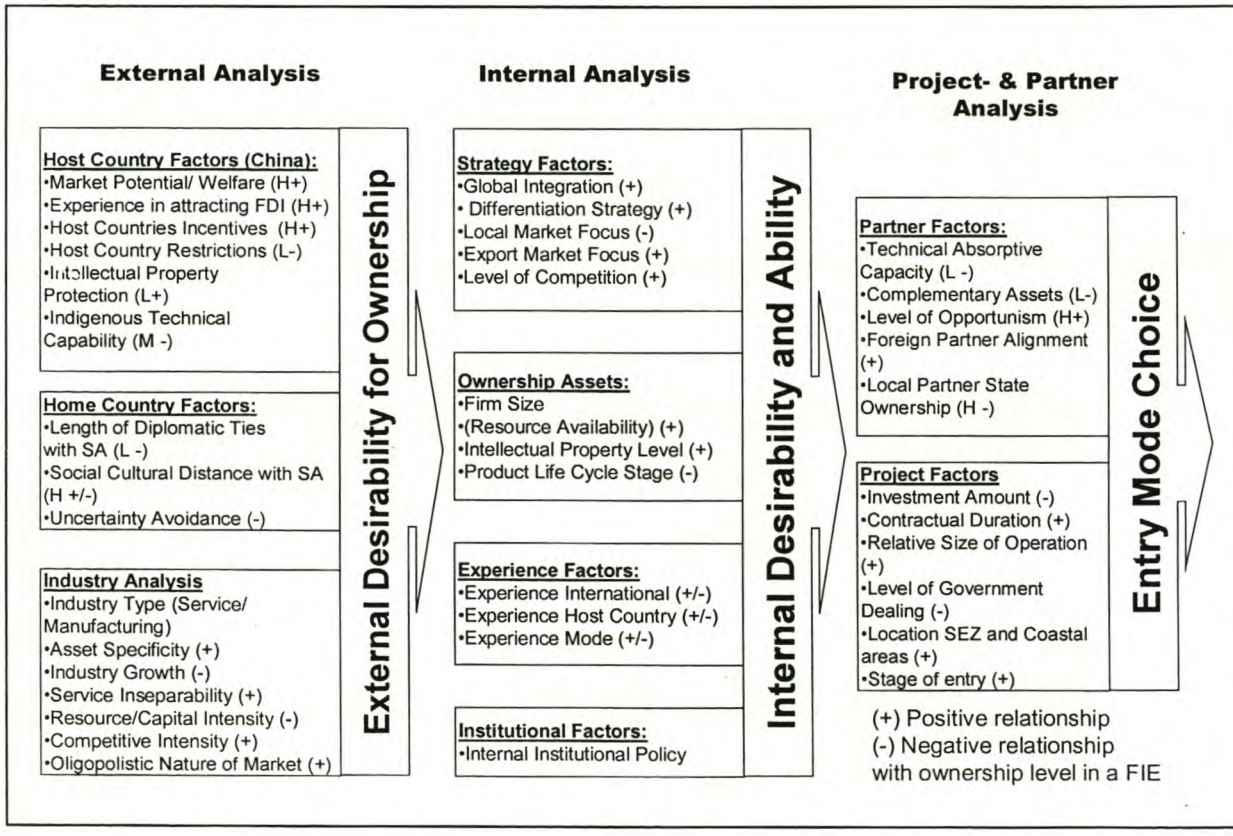
7.2 Conclusions

Although tempted to provide simple right or wrong answers to the foreign investor in China, this study has pointed out that no simple entry mode answers exist. Existing entry models or frameworks were found inadequate to provide guidance for the foreign investors. These frameworks are fragmented and too narrow focussed in terms of its theoretical departure points. The entry mode choice depends on a host of factors from a number of theoretical perspectives. The relative strength of these factors in the host country, industry and firm-specific environment will determine what ownership level a foreign investor should adopt in China.

Chapter 6 reconciled the Chinese business environment with the general research on entry mode choice. China-specific determinants were identified and incorporated into the entry mode decision framework. The framework suggested a phased approach in analysing the market entry mode decision. Firstly an external analysis of the host-, home- and industry factors should be performed. Secondly, an internal analysis of the firm's strategy, assets, policy and experience should be carried out, while a review of partner and project factors should lastly be performed.

The impact of China-specific determinants on the foreign entrant's ownership was assessed. The highlighted sections of Figure 56 summarise the assessment and impact of each China-specific entry mode determinants.

Figure 56: An Integrated Market Entry Mode Decision Framework for Foreign Investors in China (MEMDFFIC)



In order to provide even clearer guidance to the foreign investor in China, Table 23 provides a list of typical conditions that need to be satisfied before a foreign entrant should adopt a WFOE or an EJV. This list only represents the two ends of the control continuum, and the

relative strength of each determinant will determine which ownership level the foreign investor will adopt.

Table 23: Preferred Conditions for WFOE's vs. EJV's in China

Factors	WFOE	EJV
Host Country Determinants	High market potential	High incentives for EJV
	Much FDI experience	
	High level of incentives	Restrictions on WFOE's
	Weak IPR protection	High ITC
	Low ITC	High level of country welfare
Home Country determinants	Cultural distance very high	Cultural distance very high
	Cultural distance low	Cultural distance medium
	Uncertainty avoidance high	Low uncertainty avoidance
Industry Determinants	High asset specificity	Fast industry growth
	Service inseparable	Service separable
	Competitive intensity high	High capital intensity
	Oligopolistic nature of market	
Strategic Determinants	Global Strategy – Integration	Multi-Domestic Strategy
	High differentiated products	Standard/ low cost product
	Export market focus	Local market focus
	High level of competition	
Ownership Assets	High level of resources available	Lower level of resources available
	High level of intellectual property to transfer	Transfer standard product
	Early in project life cycle	Transfer mature technology
Experience Determinants	High home country and international experience	Medium international and host country experience
	Very low international exp.	
	WFOE experience high	EJV experience high
Institutional Determinants	High internal isomorphism	Low internal isomorphism
Partner Determinants	Partners lack complementary assets	Partners possess high level of complementary assets
	Low level of TAC	High level of TAC
	High level of opportunism	Low level of opportunism
		High level of state ownership
Project Determinants	Long Project Duration	Shorter project duration
	Relatively big to parent firm (important to parent)	Big project investment amount
	Deal with a lower level of government	Deal with higher levels of government
	Locate in SEZ and open coastal cities	Locate outside SEZ and open coastal cities
	Later or experience stages of entry	Earlier stages of entry

The external analysis of the Chinese host country factors suggested that its relatively high market potential, experience in attracting FDI, and weak intellectual property protection will provide a very high incentive for foreign investors to utilise full control entry modes when

entering into China. Chinese partners' high level of opportunism, low levels of technical absorptive capacity and lack of performance will intensify foreign investors desire to take full control over their foreign operations in China. On the other hand, government restrictions in certain sectors will prevent foreign entrants' utilising WFOE's or majority EJV's.

MNC's following a global strategy, who have relatively high levels of international and host country experience and are transferring high level of intellectual property will be advised to utilise a WFOE when entering into China, provided it has sufficient resources. On the other hand, firms entering into fast growing industries that lack the required experience, market access, government connections and are transferring lower levels of intellectual property, should utilise an EJV.

South Africa's relatively short diplomatic relationship and high cultural distance from China, coupled with lack of host country experience will reduce the motivation of South African firms' to utilise WFOE's in China. However the weak intellectual property protection and the large potential market potential of China may still persuade South African firms to adopt a WFOE when entering China.

Finally, foreign entrants to China should take caution not to simply utilise a WFOE in China. Firstly, the empirical work of Pan, Li & Tse (1999), and Pan & Chi (1999) have clearly shown that EJV's performed better than both WFOE's and CJV's in terms of profitability and market share. Secondly, this study suggested an evolutionary approach to entering the Chinese market. A representative office should be used for the first phase of entry to do market research, establish relationships with the government, customers and potential partners. If an entrant lack international and host country experience, it will be fruitful to first transfer mature technology on a limited scale in an EJV. Upon gaining the valuable market and host country experience, subsequent transfers of high technology can be done through WFOE's.

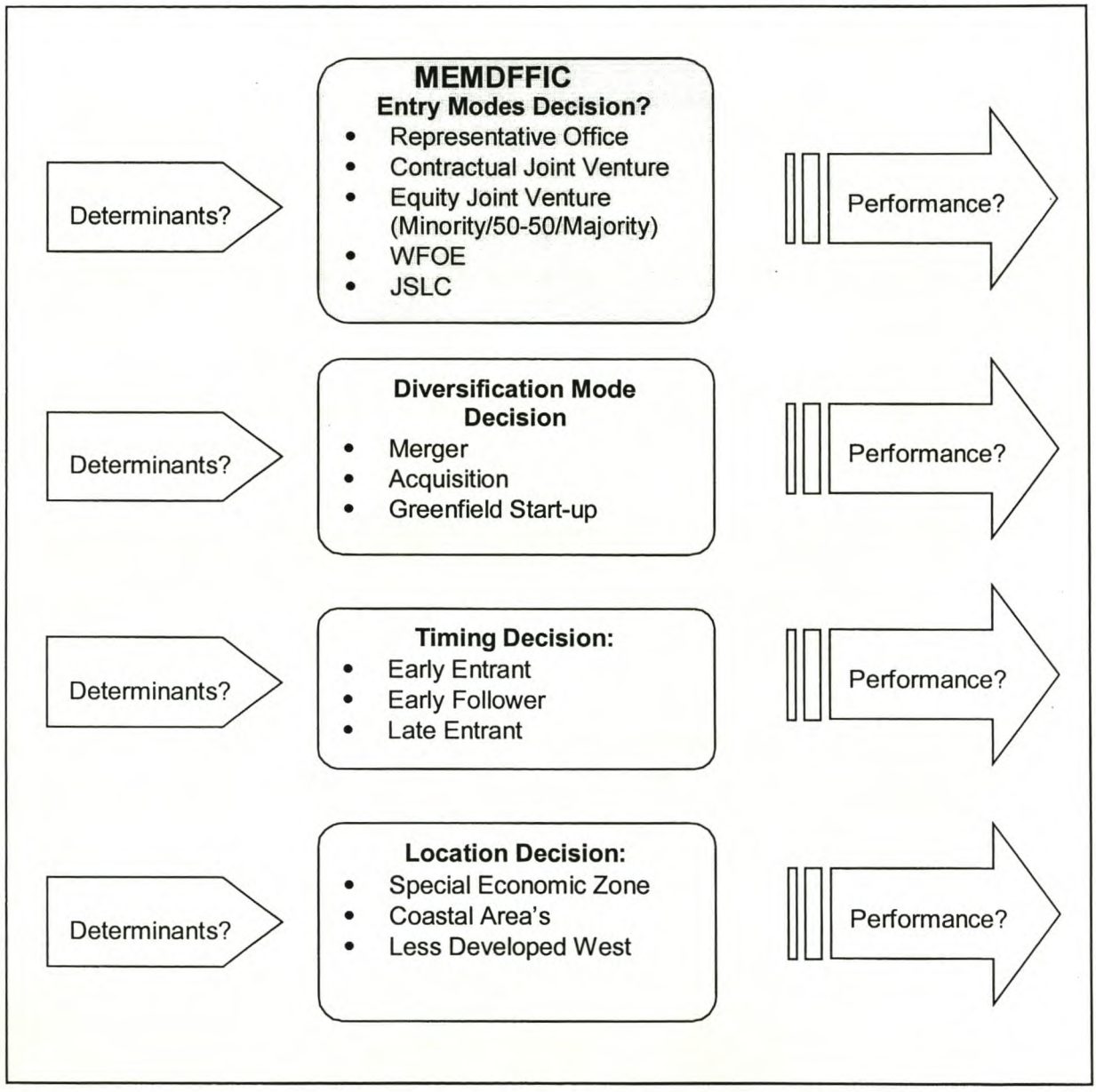
7.3 Recommendations

This study added value in two ways. Firstly, it integrated all the dominant theories of entry mode choice in a logical framework for considering entry mode decisions. Previous studies were limited to only one or a few theoretical departure points. Secondly, it applied the framework to the Chinese business situations and made propositions for the China-specific situation.

Two limitations of the study should be noted. Firstly, only a literature review was employed and as a result the propositions were not empirically tested. Secondly, entry mode choice was studied in isolation from other market entry strategy factors.

Recommendations are firstly, that the MEMDFFIC should be empirically tested on a representative sample of MNC's in China. Secondly, the framework should be extended to include other aspects of the market entry strategy. Figure 57 indicates the MEMDFFIC dealt only with the entry mode decisions, while the diversification-, timing and location decisions should be incorporated.

Figure 57: Market Entry Strategy Decision Framework for Foreign Investors in China.



The diversification mode deals with the question of whether to enter the market by means of an acquisition or to develop the new venture internally (Hennart & Reddy: 1997, Busija et al: 1997, Capener: 1998; UNCTAD: 1999, Zeira & Newburry: 1999; Milman: 1999, Mata & Portugal: 2000; Hennart & Reddy: 2000; Chi: 2000, Brouthers & Brouther: 2000). Entry timing deals with the question of whether to be an early entrant, early follower or late entrant (Mascarenhas: 1992; Saggi: 1998, Luo, Y. 1998, Chen: 1999, Isobe et. al.:2000) while the final decision will be a choice on where specifically to locate the new project (Erramilli & Argwal et al.: 1996, Chen & Chen: 1998). Research on these three areas need to incorporate both the determinant and performance dimensions.

Finally, the most important next step to enhance the MEMDFFIC will be to empirically research the relative importance of each entry mode determinant or group of determinants. Once the relative weight of each factor is determined, foreign entrants will be able to utilise the framework very accurately as a predictor of ownership level in a foreign invested enterprise in China.

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